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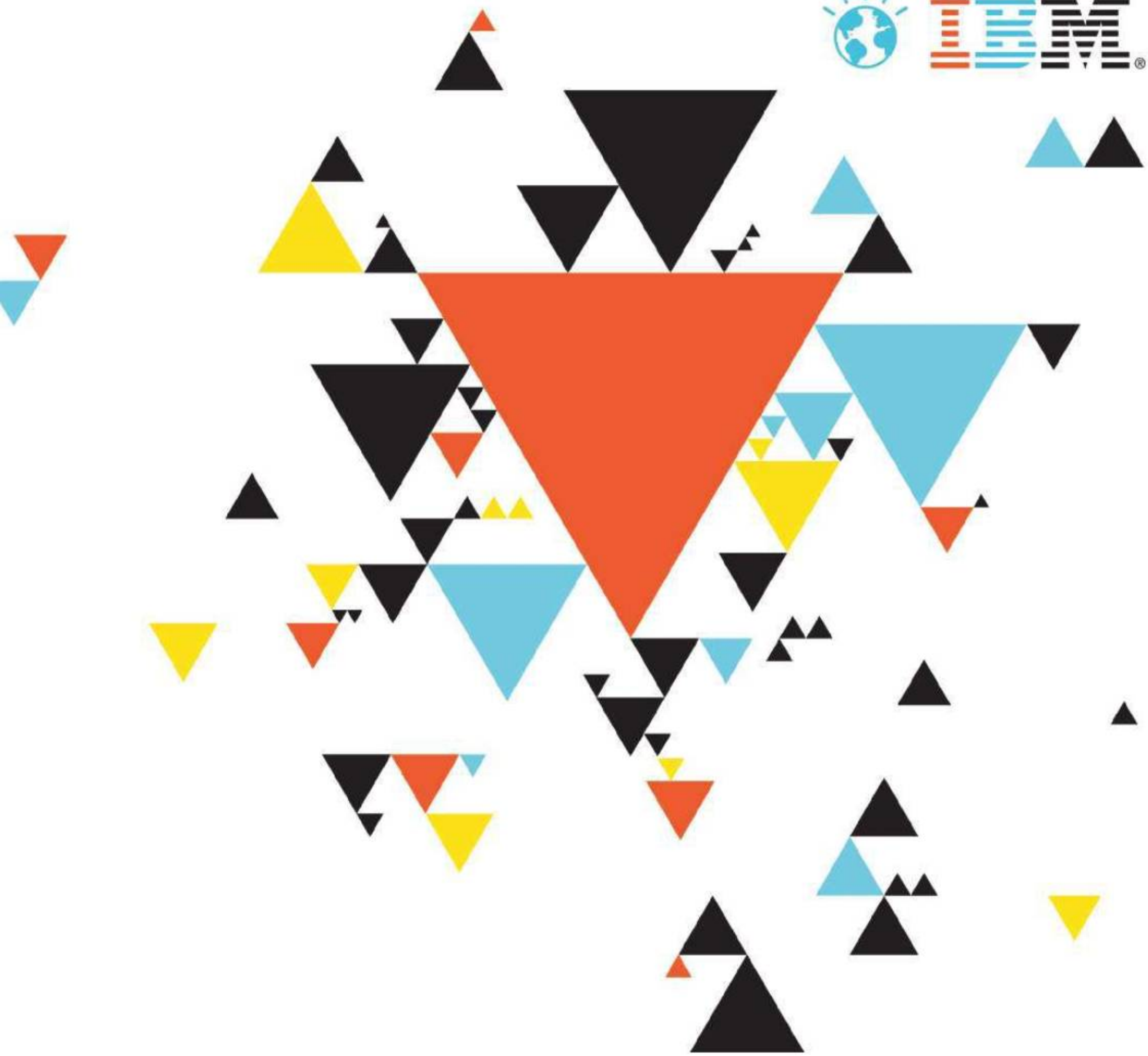
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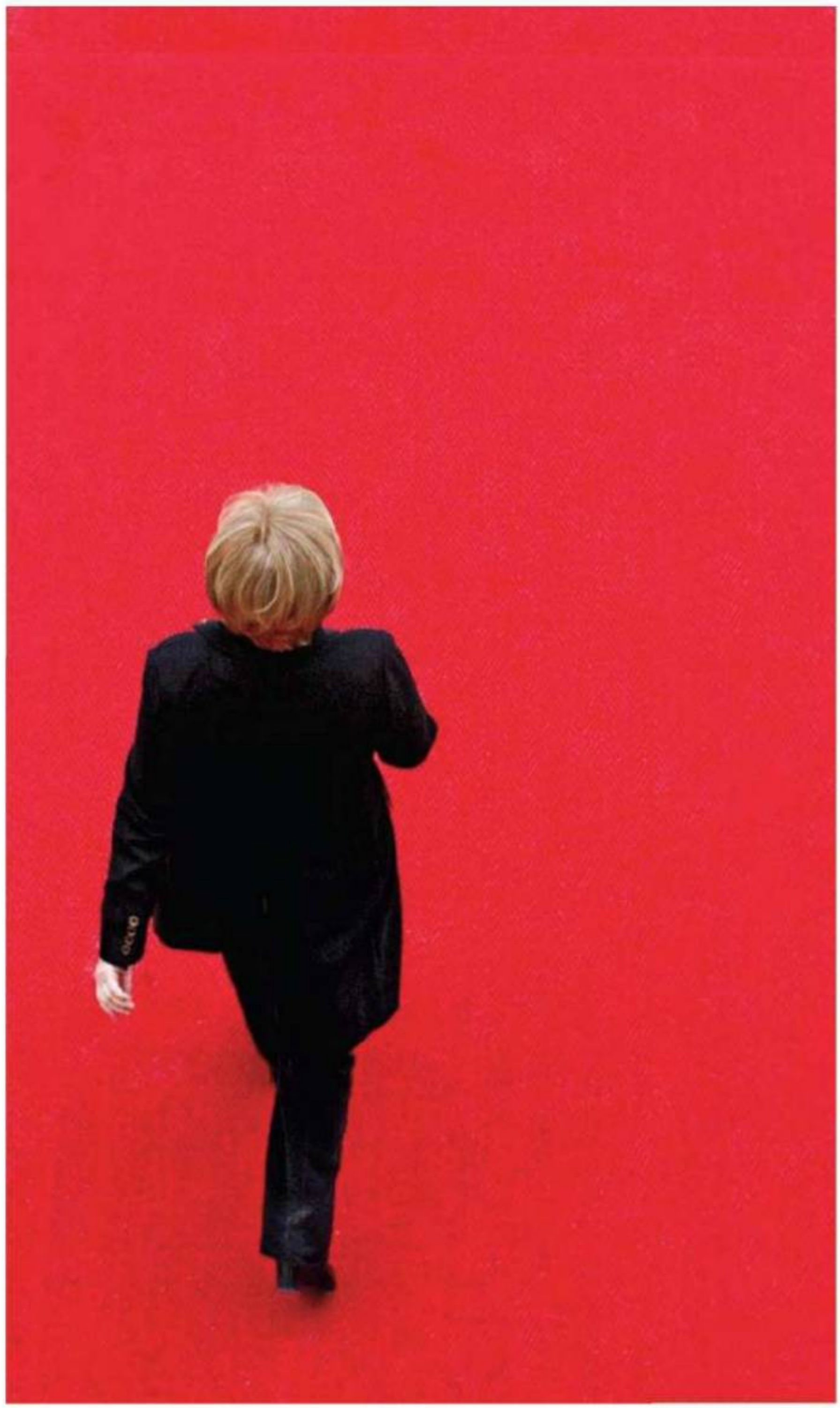
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Merkel's image as a cautious leader and fiscal conservative will be tested

COVER IMAGE BY ERIC FEFERBERG/AFP/GETTY IMAGES (IMAGE DIGITALLY ALTERED BY BUSINESSWEEK)
(THIS PAGE) PHOTOGRAPH BY FABRIZIO BENSCH/REUTERS

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BusinessWeek The Global Report



Empty office space in Beijing

The Week in Business

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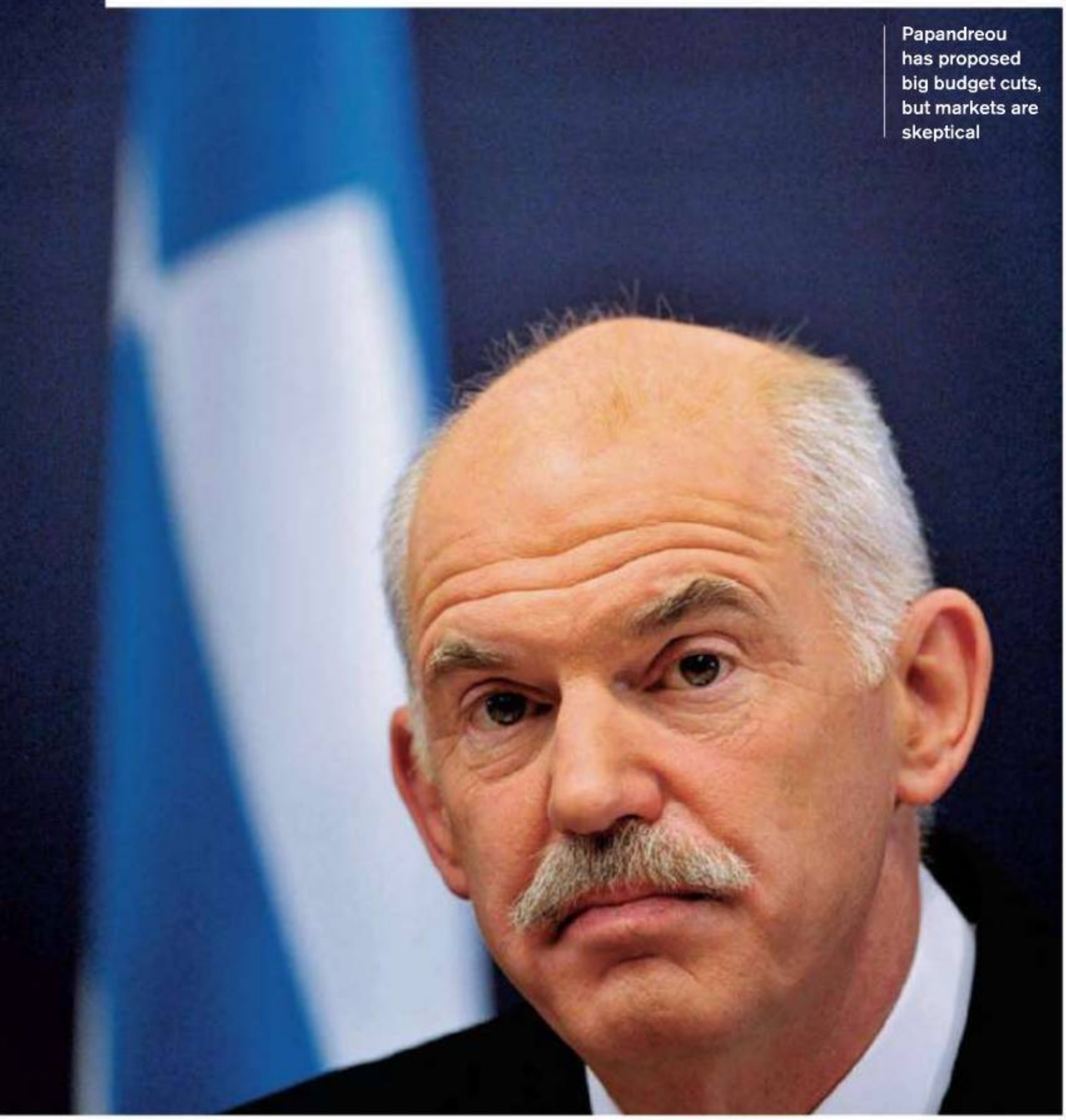
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THE WEEK IN BUSINESS



Papandreou has proposed big budget cuts, but markets are skeptical

ECONOMICS & POLICY

SHAKING A FINGER AT GREECE

The **European Union** is stepping up its efforts to rehabilitate the debt-ridden bad boy of the Continent. On Feb. 16, EU finance ministers gave **Prime Minister George Papandreou** one month to show progress in slashing Greece's budget deficit, which in 2009 reached 12.7% of GDP, to 8.7% this year. The government already has announced $14.5 billion in budget cuts and tax hikes, but markets remain unpersuaded, unions are taking to the streets, and more unrest is expected as Papandreou & Co. rein in overspending. If the EU isn't satisfied with Greece's plan by Mar. 16, it may demand specific measures such as new taxes. It also will carry out quarterly progress reviews. The ministers remained studiously vague about a possible bailout. In an upbeat signal from the bond market, Spain—another indebted southern European country—easily raised $6.9 billion on Feb. 17. The yield on the 15-year bonds was 4.65%, slightly higher than previous placements, which helped spur investor demand.

| BW | PAGE 24 **"She's Got the Whole Euro in Her Hands"**

CHINA TAPS THE BRAKES

As China enters the Year of the Tiger, it's taking steps to tame roaring growth. GDP leaped at an annual rate of 10.7% in the last quarter of 2009, and housing prices rose 9.5% in January over the year before. So on Feb. 12 the central bank ordered financial institutions to set aside more reserves for the second time in a month. That sends a message to ease off on lending: The $204 billion in loans made in January amounts to almost 20% of this year's planned total. China watchers expect more tightening, with steeper interest rates virtually certain this year. And **Goldman Sachs** chief economist **Jim O'Neill** predicts that Beijing could soon allow the yuan to appreciate by as much as 5%, while

U.S. INDUSTRIAL REVIVAL



Data: Federal Reserve

PHOTOGRAPH BY DIDIER LEBRUN/GAMMA/ZUMA PRESS; CHART BY ALBERTO MENA/BW

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other analysts figure the currency won't shift until late 2010.
| BW | PAGE 18 "The Building Bubble in China"

STAGFLATION IN BRITAIN?

Britain's economy is huffing and puffing, with jobless claims jumping unexpectedly by 23,500 in January, to 1.64 million, the highest level since April 1997. The unemployment rate stayed steady at 7.8%. Paradoxically, inflation is also acting up: On Feb. 16 the government said consumer prices rose 3.5% in January over the previous year, a 0.6-percentage-point leap from the December figure. That's the second-highest monthly increase since the index now in use was launched in 1996. Economists pointed to an increase in the sales tax and rebounding oil prices as a reason for the January inflation number, which is much higher than the official target of 2%. The **Bank of England** tried to calm fears by expressing confidence that inflation would ease in coming months.

BAYH STEPS DOWN

Already staggered by the loss of **Ted Kennedy's** Massachusetts Senate seat, Democrats took another body blow on Feb. 15 when Indiana **Senator Evan Bayh** said he won't run for a third term. A prominent and popular moderate Democrat, Bayh had won both his Senate races in a Republican-leaning state with more than 60% of the vote and had seemed highly likely to win reelection. His exit put the seat very much up for grabs in an electoral season fraught with pitfalls for his party. Adding insult to injury, Bayh used his announcement to denigrate the Senate as gridlocked. "There is too much partisanship and not enough progress—too much narrow ideology and not enough practical problem-solving," he said. "Even at a time of enormous challenge, the people's business is not being done."
| BW | PAGE 10 "Why He's Sick of Washington"

NUCLEAR PLANTS ARE BACK

With much fanfare, **President Barack Obama** announced on Feb. 17 that the **Energy Dept.** had approved $8.3 billion in loan guarantees to help **Southern Co.** build two nuclear reactors in Georgia. Obama said the project would create jobs and generate clean power—and stressed that the move is evidence of his willingness to meet Republicans halfway in the national energy debate. The pledge draws from $18.5 billion in federal loan guarantees approved in 2005 by Congress. In his State of the Union address in January, Obama said he wants to triple the amount to $54 billion in order to build up to 10 nukes. Don't expect much GOP support for Obama's overall energy policy: After his speech, Republican leaders continued to call the cap-and-trade climate-change bill an "energy tax."

TECHNOLOGY

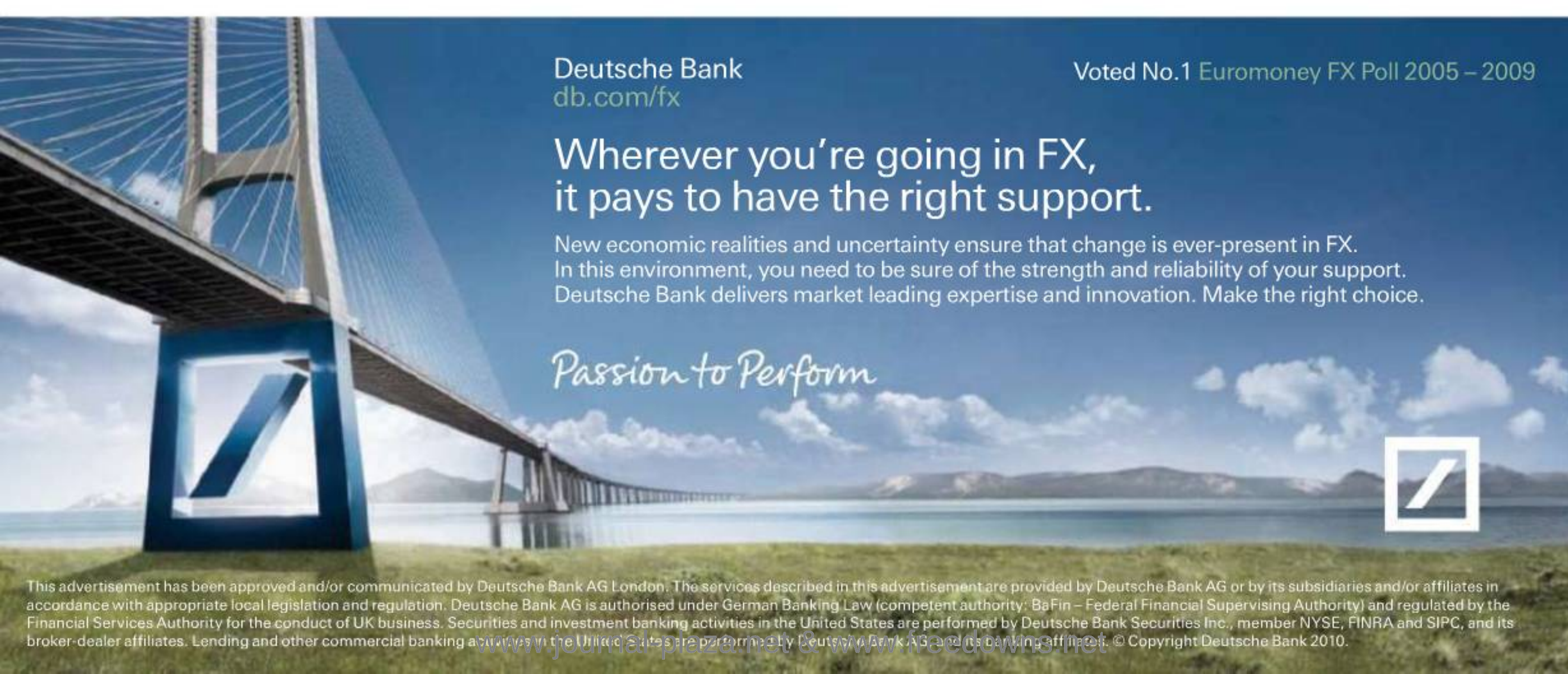
BAD BUZZ FOR BUZZ

Google customarily releases new Internet tools in Beta versions before they're perfected. That technique backfired with **Google**



Google President Sergey Brin: The company pledges to fix its mistakes on Buzz

ROBERT GALBRAITH/REUTERS



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EXECUTIVE SUMMARY



With growth slowing in India, Bharti Airtel is looking to Africa

AJAY VERMA/REUTERS

Buzz, a social-networking service aiming to compete with **Facebook** and **Twitter.** Following its release on Feb. 9, numerous bloggers complained that Buzz allowed anyone to see the names of people its users communicate with regularly. In response, Google apologized and said it's making privacy controls more prominent. "We quickly realized that we didn't get everything quite right," said **Todd Jackson,** product manager for Buzz, in a post on the company's blog. Meanwhile, the search giant isn't neglecting its core business: On Feb. 12 it acquired **Aardvark,** a service that taps the knowledge of friend networks to make search results smarter.

STRATEGY

BATTLE OF THE MALL GIANTS

It's a faceoff between two titanic families: the **Bucksbaums,** who founded **General Growth Properties** with a single Iowa shopping center in 1954, and the Simons, who control **Simon Property Group,** the biggest mall operator in the U.S. On Feb. 16, Simon offered $10 billion for its rival, which literally shopped till it dropped last April, falling into bankruptcy after running up $27 billion in debt making acquisitions. Simon's bid comes to about $9 a share, plus $7 billion in assumed debt. General Growth spurned the offer, and investors pushed the stock past 12, betting on a rival bid or a sweetened deal.

BHARTI AIRTEL'S AFRICAN BID

As competition picks up at home, Indian and Chinese cellular operators are dialing Africa for growth. Bharti Airtel, India's largest phone company, has begun exclusive talks with Kuwait-based **Zain** to buy Zain's African mobile business, the companies announced on Feb. 15. Bharti, which last year failed for the second time to buy South Africa's **MTN Group,** will offer $10.7 billion (including $1.7 billion in assumed debt) to Zain, which operates in 15 African nations. The companies set a Mar. 25 deadline to make a deal.

TOYOTA: MORE BODY DAMAGE

Mr. Toyoda goes to Washington? Not this week. **Toyota Motor President Akio Toyoda** said he will not attend congressional hearings on Feb. 24 that will probe the recall of Toyota's cars. Instead he'll send the company's North American chief, **Yoshimi Inaba,** Bloomberg News reported on Feb. 17. A spokesman for **Representative Darrell Issa** (R-Calif.) criticized the carmaker's CEO, saying that he "is not as eager to give Congress and the American people answers as we first thought." Toyota, which has recalled more than 8 million cars this year, said on Feb. 17 that it's investigating the power steering in its popular Corolla compact and may recall the model.

| BW | PAGE 14 "Did Toyota's Traffic Cops Sway the Regulators?"

THE OPTIMISM METER

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The Meter climbed to 46 on Feb. 16, up from a seven-month low of 31 one week earlier as positive attitudes toward the U.S. stock market, real estate, and employment all increased by more than 10%. Developed by ***Bloomberg BusinessWeek*** using data from pollster **YouGov,** the Meter is a proprietary measure of sentiment and expectations, economic statistics, and market forecasts. It evaluates shifts in outlook among individuals, professional investors, and economists in the areas of U.S. economic growth, jobs, equity markets, and real estate.

Calculated using consumer polling, economic forecasts, and financial markets data; 0=lowest and 100=highest Data: YouGov, *Bloomberg BusinessWeek*

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·TEAMWORK·

is rarely inspired by posters of skydivers holding hands.

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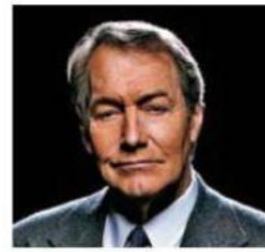
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AT THE TABLE CHARLIE ROSE



EVAN BAYH
Why He's Sick of Washington

On Feb. 15, Senator Evan Bayh, a centrist from Indiana and the scion of a prominent political family—his father is former Senator Birch Bayh—surprised colleagues on both sides of the aisle by announcing he would not seek a third term in November. Bayh, who has been frequently mentioned as a possible Presidential candidate, cited gridlock and Washington's toxic partisanship as reasons for his decision. I talked with Bayh two days later.

CHARLIE ROSE
Why—and why now?

SENATOR EVAN BAYH
Well, it was a deeply personal and difficult decision. I'm an idealist but I'm also a pragmatist, and at this moment I can make a more significant contribution to our country and my state by being in the private sector, either with a university, a philanthropy, or helping to create jobs by expanding a business. Part of it is I'm an executive at heart. I was privileged to be governor of my state for about eight years ... and so perhaps my expectations for the [Senate] are a little bit higher because of that. But the level of polarization and gridlock right now is just much higher than I've seen before, certainly higher than in my father's time.

Did you talk with your father, and what was his counsel?
He said to me: "Son, do what you think is right and everything else will work itself out." He does agree that the institution is not what it was back in his day. There were a lot more friendships across the aisle then. He tells



Bayh, with wife Susan and sons, announcing his decision

(FROM TOP) BRAD TRENT; MATT DETRICH/*INDIANAPOLIS STAR*/PSG

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a story about his first reelection in 1968. The Republican leader, Everett Dirksen, came up to him on the floor of the Senate and asked him what he could do to help. You would never see that kind of thing today. Members raise money for other members' opponents, they campaign against each other. That kind of culture really makes it much harder to sit down and forge consensus when you know the folks on the other side are trying to do you in.

How did we get to this point?
I think there are many contributing factors. The House has been deeply damaged by the gerrymander. Out of 435 seats, there are maybe only 15 competitive ones. So the real elections are in the primaries. If you're in a majority Democratic district, you go farther to the left to avoid a challenge, and the opposite occurs on the Republican side. And you end up having many more people on the far right and the far left and fewer ones in the middle where I think most Americans find themselves and where a real consensus gets accomplished. The pervasive need to fund-raise is also a factor. Back in my father's day, the old adage was you legislate for four years and you campaign for two. Now, because of the vast sums of money that have to be raised, there's a perpetual campaign. And if all things political are constantly at the forefront of your mind—the need to raise money, the desire to avoid a bad quote that might lead to a 30-second ad, that kind of thing—it just makes consensus more difficult to achieve. And I do think the two parties seem to be disproportionately influenced by their most fervent elements, who view a compromise as some form of betrayal. Other than ceremonial occasions, I can recall only twice when all 100 senators gathered together to focus on a problem of national import. The first was when the President had been impeached. The second was three days after 9/11.

Why not stay and fight?
First, I've devoted my entire adult life to doing exactly that ... and unless my doctor has some surprise news, I'm not about to die or go away. I intend to continue to fight for the things I think are right for my country.

Some say that when you came to the Senate, people began to think of you as Presidential timber. And when that didn't happen, you found less reason to be in the Senate.
Well, the speculation was flattering, and there was a time when I thought about [running for President]. Fortunately, I went back on my meds and got those aspirations out of my mind.



Third-party opening? Anti-taxers in Seattle

STEVE BLOOM/THE OLYMPIAN/AP PHOTO

Or not.
Well, they're out of my mind, let me assure you. Only a handful of people have gotten to be President, so God help us if that's, you know, the only way you can contribute.

Did you have a serious conversation with the President—not the President's chief of staff—about this decision before you announced it?
I've talked to the President. I'm not going to divulge the content of our conversations. But I've had several conversations with him in the last year.

But not in the last week or so?
I didn't call the night before or that kind of thing. He's a busy man.

THE HOUSE HAS BEEN DEEPLY DAMAGED BY THE GERRYMANDER. OUT OF 435 SEATS ... MAYBE ONLY 15 [ARE] COMPETITIVE

But the sense is that this decision was made in the last week, that while you might have been brooding about it, a decision point came.
The President was well aware of some of the frustrations I felt about Congress. Let me just say one of the reasons my decision was made when it was made is because some of the leaders of our country asked that I reconsider, and I felt it was appropriate that I give those requests the respect they deserve.

My friend *New York Times* columnist David Brooks believes there is an opportunity for a third-party candidate if the President runs for reelection and someone from the right of the Republican Party is the nominee.
There's a high level of frustration with the two-party system out there. Let me be clear: I support the President. I think he very much wants to be a change agent. He's making a sincere effort. But not enough members of Congress are listening, either because of partisan or ideological reasons. I believe the President will be a strong favorite for reelection, certainly as the economy improves. But I do think David is on to something. This is—for lack of a better phrase—"a Ross Perot moment." You remember back then, the deficit was unsustainably high. The economy was struggling. People had a sense that Washington was broken, and they looked for someone from outside the system. If the economy does not improve and these deficits and debt are just allowed to run up, and you get a reaction in the global credit markets that causes a collapse of the dollar or a dramatic spike in interest rates, that could be the kind of thing that would really galvanize public opinion against everyone in Washington—regardless of party. | BW |

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BUSINESS OUTLOOK | RICH MILLER

FOR THE FED, IT'S ALL IN THE TIMING

Bernanke has said plenty about how the central bank will tighten credit to forestall inflation. But Congress really wants to know whether a hike will come before the fall elections

Despite the 3½-foot snowfall that shuttered Congress, Federal Reserve Chairman Ben Bernanke managed to grab headlines on Feb. 10 when he delivered testimony on the central bank's "exit strategy" to the snowbound lawmakers via e-mail. Bernanke's 11-page exegesis on unwinding the Fed's ultra-easy monetary policy and ultimately raising interest rates was filled with plenty of detail on the "how." But when lawmakers query Bernanke in person, during the Fed's semiannual economic report to Congress on Feb. 24, their biggest question will be: "When?"

That's no surprise, given that this is an election year, with embattled Democrats fighting to retain control of Congress. During his testimony, Bernanke is sure to resist anything that looks like a timetable for tightening. In the end, though, he may be able to give lawmakers what they really want—steady interest rates until after the fall elections—provided he gets a little help, from both China and Congress itself.

It's a toss-up as to whether the Fed raises rates ahead of the election, according to Feb. 16 prices on the Chicago futures markets (chart). Traders peg the chance of a rate hike at the Fed's Sept. 21 meeting at a bit under 50%. The odds of a move at the central bank's subsequent meeting, however, jump to about 2 in 3. It's easy to see why: The meeting is scheduled to end the day after Americans go to the polls.

$2.2

The size of the Federal Reserve's balance sheet (in trillions) on Feb. 10, 2010
Data: Federal Reserve

Since last March, the Fed's mantra on interest rate policy has been simple and consistent: The short-term rates it controls are likely to remain "exceptionally low" for an "extended period." Bernanke reiterated that in his Feb. 10 virtual testimony and is likely to repeat it again on Capitol Hill next week. Many in the financial markets see that as tantamount to a promise not to raise the rate from its current near-zero level for six months.

Fed leaders are quick to point out that their commitment on rates depends on the amount of slack and price pressures in the economy and expectations of future inflation. If those change, policymakers feel they are free to do what they want with rates.

The unemployment rate is perhaps the best proxy for how much economic slack there is right now. While its drop to 9.7% last month surprised economists inside and outside the Fed, that's still a long way from the roughly 5% level that policymakers consider as meeting their congressionally mandated goal of full employment.

That suggests there's no need for the Fed to worry about wage-driven inflation soon. In fact, employers' labor costs, including pensions and other benefits, rose at an annual rate of just 1.5% in the fourth quarter of 2009.

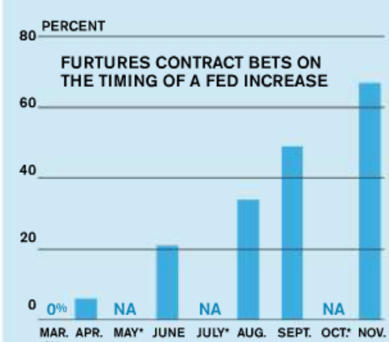
What price pressures there are in the economy reside in goods, not labor-intensive services. Prices on everything from gasoline to clothing rose at an annual rate of 5.8% in December, more than double the 2.8% increase in the overall consumer price index (of which goods are a component).

This is where China could provide some help to Bernanke. Surging Chinese demand drove global commodity prices about 50% higher last year, contributing to the rise in goods prices in the U.S. If Beijing succeeds in its recently launched efforts to cool its economy, that will restrain the rise in commodity prices—and take pressure off the Fed to raise interest rates.

Bernanke is doing his part to keep inflation fears tamped down by continually talking about tools the Fed has for managing its bloated balance sheet (up 165% since 2007) and removing all that liquidity from the economy. But he could use some help from Congress in getting that message across.

Some investors fear political pressure will keep the Fed from tightening credit in time to keep inflation at bay. A nagging concern: a bid by Representative Ron Paul (R-Tex.) to subject Fed monetary moves to second-guessing by Congress' Government Accountability Office. A quick decision to quash the proposal would help ease investors' inflation fears. That in turn would give the Fed more latitude to keep interest rates low—and lawmakers happy. | BW |

FEARS OF AN ELECTION SEASON RATE HIKE



*No fed meeting
Data: CME Group, Bloomberg calculations

CHART BY ALBERTO MENA/BW

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NUMBERS

Deep Cuts: The construction industry has seen the biggest decline in total employment.



Data: Bureau of Labor Statistics *As of Jan. 2010

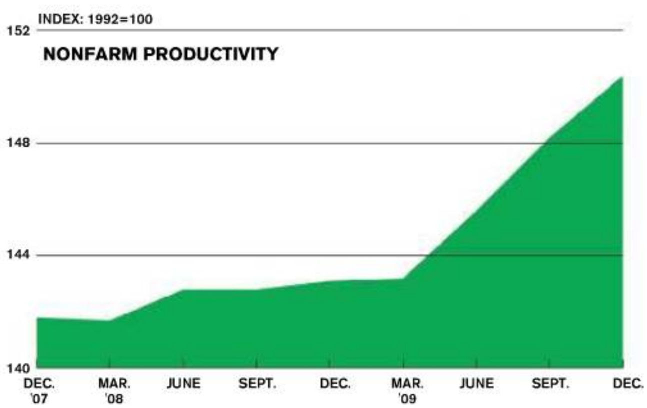
THE SECRET OF U.S. PRODUCTIVITY GAINS: JOB CUTS

By Tara Kalwarski/Charts By David Foster

The productivity of nonfarm U.S. businesses has increased by 6% since the end of 2007. That's because there are fewer workers, but those who remain are producing more per hour. Companies may need to ramp up capital spending to keep productivity growing.

More Productive...

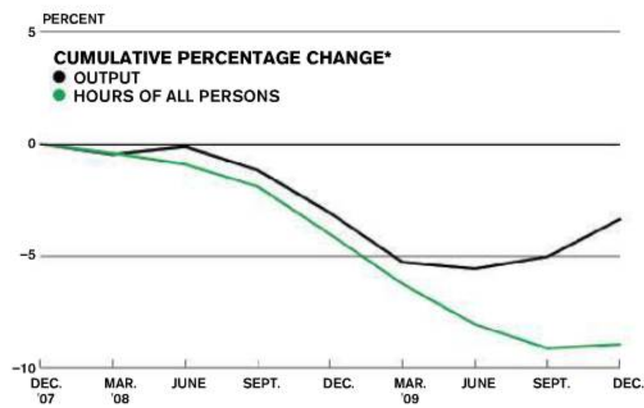
The output per hour of nonfarm workers has increased by 6.1% since the beginning of the recession.



Data: Bloomberg, Bureau of Labor Statistics

... Because Fewer Workers Are on the Job

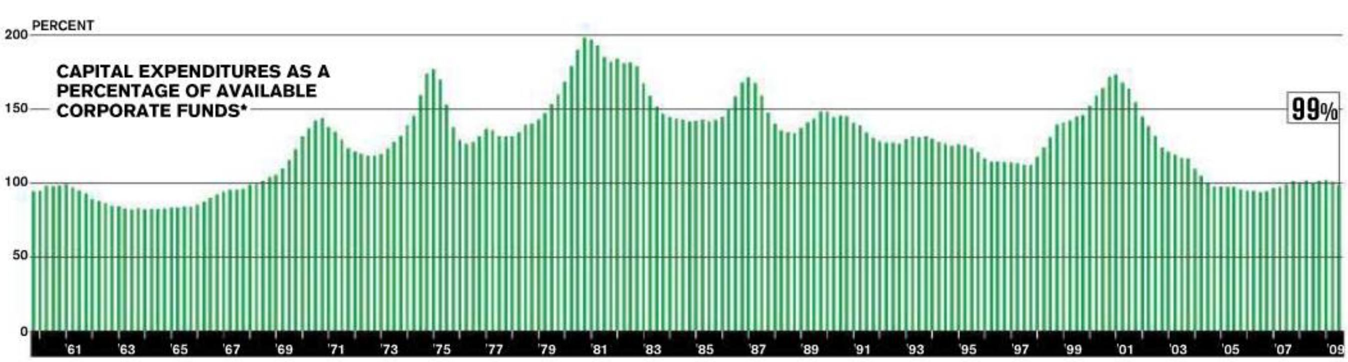
Output is only 3.4% below its December 2007 level, while the number of hours worked has fallen 8.9%.



Data: Bloomberg, Bureau of Labor Statistics *Seasonally adjusted

INVESTING IN THE FUTURE

Currently, capital spending is about on par with profits. Until recently, such spending far exceeded profits (with borrowing filling the gap).



*Rolling four-quarter average; available corporate funds equal to aftertax profits minus dividends, adjusted for depreciation and inventory valuation
Data: Bloomberg, Bureau of Economic Analysis

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Did Toyota's Traffic Cops Sway the Regulators?

The Japanese automaker fended off four U.S. probes of auto defects dating back to 2004 with the help of two former NHTSA regulators on its payroll

By Jeff Green and Margaret Cronin Fisk

The revolving door between Wall Street, the Treasury Dept., and the Fed is cited as a big reason for the lax oversight of the banks that brought us the credit crisis. Did the same problem prevent Toyota Motor and the National Highway Traffic Safety Administration from understanding the true scope of acceleration problems in the automaker's cars and trucks dating back to 2004?

A Bloomberg News review of court and government records shows at least four U.S. investigations into unintended acceleration in engine speeds of Toyota cars and trucks were ended with the help of two former regulators hired by the automaker, long before Toyota's expensive worldwide recall became news in late January. Christopher Tinto, vice-president for regulatory affairs in Toyota's Washington office, and Christopher Santucci, who works for Tinto, joined Toyota directly from NHTSA—Tinto in 1994 and Santucci in 2003—and both represented the world's biggest automaker on controversial safety cases.

While all automakers have employees who handle issues with NHTSA, Toyota may be alone among the major companies in employing former agency staffers to do so. Spokesmen for General Motors, Ford Motor, Chrysler, and Honda Motor all say their companies have no ex-NHTSA people who deal with the agency on defects. "Toyota bamboozled NHTSA or NHTSA was bamboozled by itself," says Joan Claybrook, an auto safety advocate and former NHTSA administrator in the Carter Administration. "I think there is going to be a lot of heat on NHTSA over this."

On Feb. 16, NHTSA Administrator David L. Strickland ordered Toyota to release documents that show when it became aware of safety issues related to malfunctioning accelerators and floor mats pinning down gas pedals. Three congressional committees have scheduled hearings on the carmaker's recall, though Toyota President Akio Toyoda has so far declined to testify. Problems with Toyota and Lexus models have been tied to as many as 34 deaths from 2004 to 2009, and the recall has since widened, for a total of more than 8 million cars, to include possible brake problems with the Prius hybrid.

U.S. regulators say Toyota hasn't gotten off easily. In an e-mailed response to questions about possible influence of former NHTSA employees on the agency's Toyota decisions, Transportation Dept. spokeswoman Olivia Alair said NHTSA "currently has three open investigations involving Toyota and is monitoring two major safety recalls involving Toyota vehicles. NHTSA's record reflects that safety is its singular priority."

Toyota says there was nothing untoward about the roles played by Tinto and Santucci, neither of whom was available for comment. "Anything Mr. Tinto and Mr. Santucci did was in the interest of full disclosure, transparency and openness with regulators and safety experts," Toyota spokeswoman Martha Voss said in an e-mailed statement. "Their actions have been consistent with our efforts to maintain the highest professional and ethical standards in all of our legal and regulatory practices. Their paramount concern was for the safety of every

YURIKO NAKAO/REUTERS

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Toyoda in Tokyo: Toyota's president has so far declined to testify before Congress

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single owner of one of our vehicles."

The four probes the Toyota aides helped end involved complaints that the unintended acceleration was caused by flaws in the vehicles' electronic throttle systems. Toyota has denied that the system is a problem. Transportation Dept. Secretary Ray LaHood said on Feb. 3 that NHTSA is reviewing the electronics.

NHTSA opened eight investigations of unintended acceleration of Toyota vehicles from 2003 to 2010, according to Safety Research & Strategies, a Rehoboth (Mass.) group that gathers data from NHTSA and other sources for plaintiff's attorneys and consumers. Three of the probes resulted in recalls for floor mats. Five were closed, meaning NHTSA found no evidence of a defect. In four of the five cases that were closed, Tinto and Santucci worked with NHTSA on Toyota's responses to the consumer complaints the agency was investigating, agency documents show.

The first case where NHTSA records show the involvement of Tinto and Santucci dealt with unanticipated acceleration by 2002 and 2003 Toyota Camrys and Solaras and began in March 2004. The safety agency decided to open a preliminary investigation to determine "if the throttle control system could be the cause of vehicle surge or unwanted acceleration."

Toyota had identified 114 cases where that was a potential issue. But after Santucci and Tinto met with NHTSA officials, the inquiry was narrowed to 11 incidents that resulted in five crashes, according to a deposition of Santucci in a later lawsuit (still pending) filed on behalf of the family of a Michigan woman who was killed in an April 2008 accident involving suspected acceleration problems with a Camry. Investigators back in 2004 decided to focus on cases of acceleration that lasted less than one second and those where the brake could still be used to control the vehicle.

In those instances the Transportation Dept. reasoned the cause was most likely to be mechanical or electronic in nature, rather than human error. The investigation was closed in July 2004 because of lack of evidence, agency records show.

The same pattern repeated itself in 2005 and 2006. Complaints by Toyota owners over accelerator problems made their way to U.S. traffic safety regulators. Toyota's Tinto wrote letters to NHTSA officials. ("No evidence of a system or component failure was found and the vehicles were operating as designed," Tinto wrote to regulators in 2005.) The agency ended probes in both cases in a matter of months. A 2008 federal investigation lasted eight months. Toyota had identified 478 incidents of engine-speed increases of Toyota Tacoma pickup trucks even when the gas pedal wasn't pushed. The NHTSA pursued no regulatory action.

Did the fact that Toyota had former traffic safety regulators on its payroll make a difference? The NHTSA decisions on Toyota weren't necessarily biased just because former agency people were involved, says Sidney Shapiro, a law professor at Wake Forest University in Winston-Salem, N.C. "I'm not sure regulators set out to say 'I'm going to give a special deal to my old friends in the auto industry,'" he says. "But what happens is it just sort of deteriorates because these are the only people you talk to." | BW |

–With Angela Greiling Keane in Washington, Alan Ohnsman in Los Angeles, Andrew Harris in Chicago, and Makiko Kitamura in Tokyo

U.S. REGULATORS HIRED BY TOYOTA HAVE HELPED DEFLECT PAST U.S. CAR SAFETY PROBES

Court and government documents show that Christopher Tinto, Toyota's vice-president for regulatory affairs, and Christopher Santucci, who works for him, affected NHTSA investigations into alleged acceleration problems involving Toyota cars and pickups. An overview:

2004

The NHTSA informed Toyota in March 2004 that it was opening a preliminary investigation into whether a throttle control system could be the cause of vehicle surge or unwanted acceleration in 2002 and 2003 Toyota Camrys and Solaras. Tinto and Santucci worked closely with officials at NHTSA, which narrowed its investigation to about 11 incidents involving five crashes.

Outcome: The case was closed on July 22, 2004.

2005

Another set of complaints, including one from the owner of a 2002 Camry, about unintended acceleration problems resulted in another NHTSA review. Tinto wrote the agency in November that a Toyota dealership-led review of 59 vehicles whose owners complained of acceleration issues found that "no evidence of a system or component failure was found and the vehicles were operating as designed."

Outcome: NHTSA ended its probe in January 2006.

2006

Toyota and the NHTSA also received complaints in August 2006 about accelerator issues involving the Camry, this time covering model years 2002 to 2006. In that case, Tinto wrote to NHTSA officials that Toyota had found no abnormality in the throttle controller, which the petitioner had blamed, though Toyota did find evidence that water damage from heavy rain or from driving through a flooded road may have caused problems in specific cases.

Outcome: NHTSA ended the investigation in April 2007.

2008

Toyota received complaints involving 478 incidents where Tacoma pickup truck engines (for model years 2004 through 2008) allegedly speeded up even when the accelerator pedal wasn't pushed. Tinto told NHTSA officials the automaker couldn't find enough evidence to support allegations and an investigation wasn't warranted.

Outcome: NHTSA did conduct an eight-month review but closed the investigation on Aug. 27, 2008.

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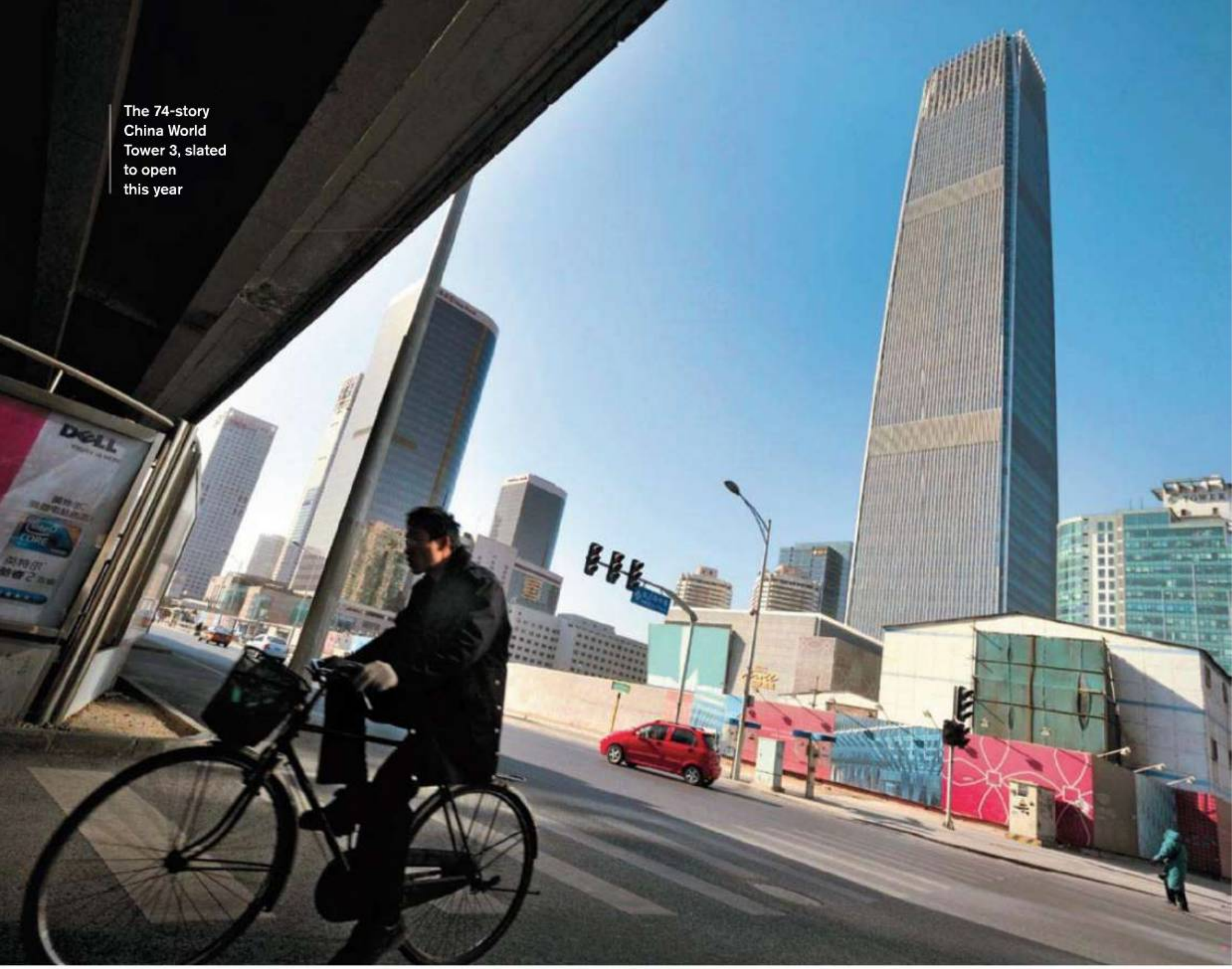
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The 74-story China World Tower 3, slated to open this year

The Building Bubble in China

Much of the country's stimulus money was spent on skyscrapers. Fears of a real estate bust have followed

By Michael Forsythe and Kevin Hamlin
BEIJING

Jack Rodman has cashed in on property busts from Los Angeles to Tokyo, buying and selling soured loans and counseling other investors. Now he's convinced the Beijing real estate market is about to tumble. Rodman figures about half of the city's commercial space is vacant, and to prove it he keeps a slide show of 55 empty office buildings in the Chinese capital on his computer. There are an additional dozen, he says, that he hasn't had time to photograph. "I took these pictures to try to impress upon people the massive amount of oversupply," says Rodman, president of Global Distressed Solutions, which advises investors on Chinese property.

Much of the $1.4 trillion in loans made by Chinese banks last year—with considerable encouragement from officials aiming to boost growth—was spent on skyscrapers and other commercial property. Now empty buildings are sprouting across the mainland. Beijing had an office vacancy rate of 22.4% in the third quarter, the ninth-highest of 103 markets tracked by broker CB Richard Ellis (CBRE). That figure doesn't include projects about to open, such as the 74-story China World Tower 3, Beijing's tallest building. "There's a monumental property bubble and fixed-asset investment bubble under way," says James Chanos, founder of New York hedge fund Kynikos Associates. "And deflating that

MARK LEONG/REDUX

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gently will be difficult at best."

Worried Beijing policymakers are trying to choke off the supply of funds fueling the property boom. On Jan. 27, the China Banking Regulatory Commission, the chief oversight body, called on banks to curb loan growth. They should "strictly" follow real estate lending policies, the commission said in a notice on its Web site. "The Chinese authorities are clearly trying to bring excessive bank lending under control," says Stephen Roach, the chairman of Morgan Stanley Asia.

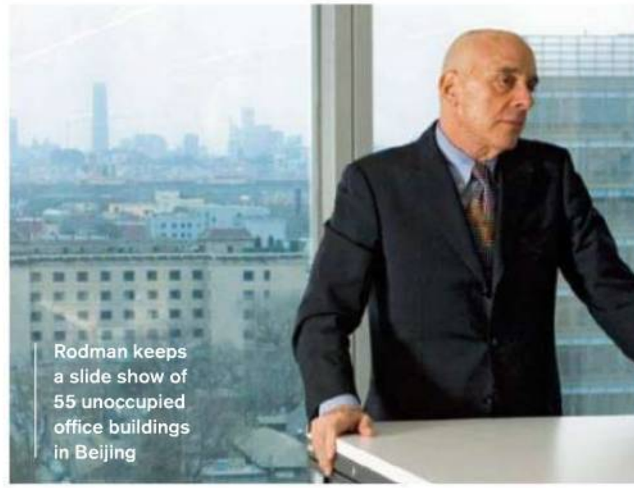
HIDDEN EXPOSURE

The central bank on Feb. 12 increased reserve requirements, the money banks must keep on hand to cover potential losses, for the second time this year. That should reduce the amount of money banks have available for new loans, helping to slow growth. Now some economists are speculating that the government could allow China's currency, the yuan, to appreciate against the dollar for the first time since July 2008. "They're close to moving the exchange rate. I think something's brewing," says Jim O'Neill, London-based chief global economist at Goldman Sachs.

If Beijing can't cool things off and the property boom turns to bust, there could be a surge in nonperforming loans. A 10% fall in property values would triple the number of delinquent mortgages in Shanghai, regulators in the city said on Feb. 4. The damage could be worse than expected because some industrial loans to state-owned companies have been used to invest in real estate, says Charlene Chu, an analyst at Fitch Ratings in Beijing. "There is a lot more hidden property exposure there than we can see," Chu says.

Despite the bubble talk, some analysts say the worries may be overblown. CBRE says vacancy rates are starting to fall and rents are rising for the best buildings as China's growth buoys demand. "In many cases when you look at these buildings and say, 'That's never going to be fully occupied,' somehow 12 to 18 months later the building is full," says Chris Brooke, CBRE's Asia chief.

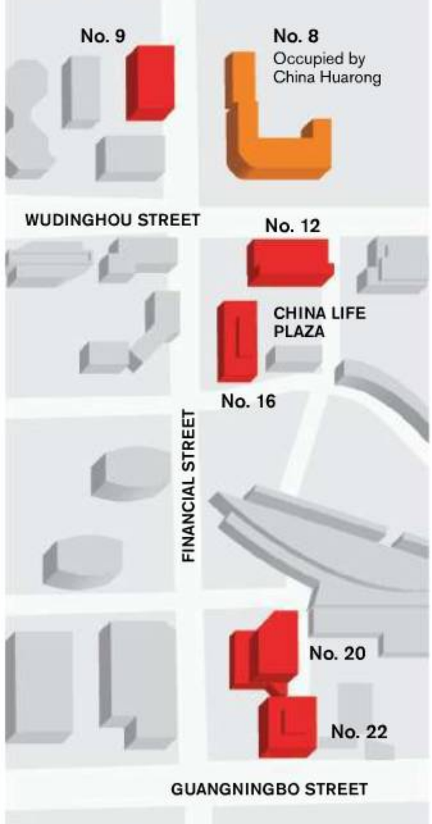
Builders, meanwhile, continue to build. Some 13 million square feet of new office space will enter the market in Beijing this year, increasing the total stock by about 13%, according to real estate adviser Jones Lang LaSalle. "We are optimistic about 2010 prospects," says Zhong Rongming, deputy general manager of the China World Trade Center Co., which developed the $965 million China World Tower 3. "China is taking the lead in the global economic recovery with a very positive economic outlook."



Rodman keeps a slide show of 55 unoccupied office buildings in Beijing

GHOST TOWN

Empty and nearly empty buildings on Beijing's Financial Street may point to a bust.



Many of the new projects are being built with help from local governments. In eastern Beijing, officials are hoping to double the size of a vast development called the Central Business District, even though its vacancy rate is 35%. Financial Street Holding, whose biggest shareholder is an arm of the municipal government, has plans for 10 million square feet of additional space starting this year.

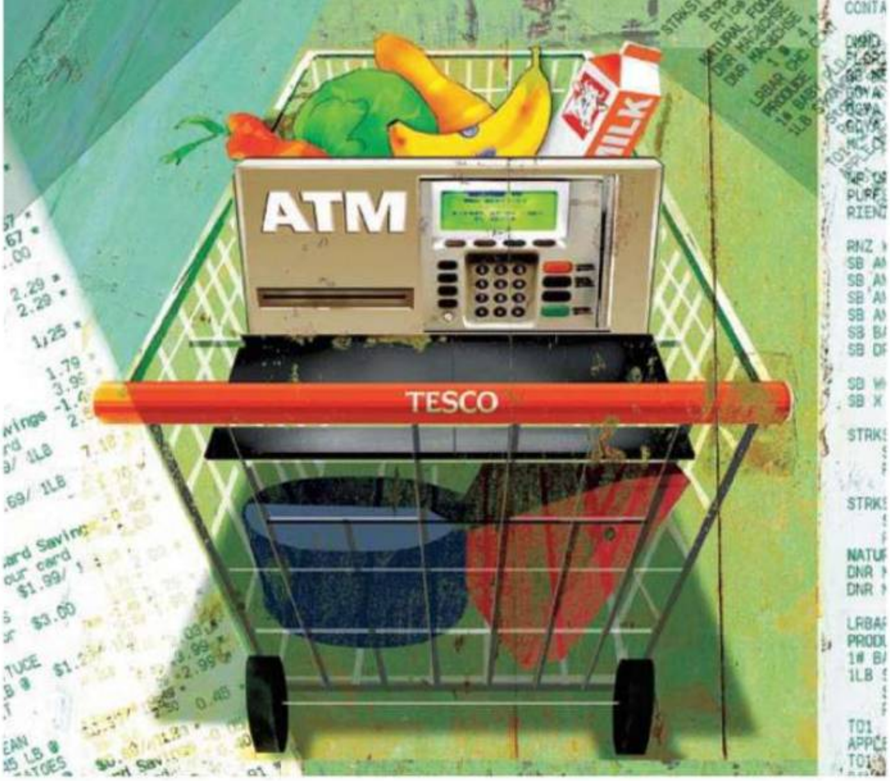
GATHERING DUST

A mile or so east of Tiananmen Square, the five towers of the Minsheng Financial Center remain nearly empty more than a year after leasing began. Across town, take a walk down Financial Street, and you'll pass No. 9, a 17-story concrete-and-glass tower that's unoccupied. One block south, no lights shine from Nos. 12 and 16, the two towers of the 18-story China Life Plaza. Two blocks farther on are another pair of 18-story buildings, Nos. 20 and 22, belonging to the Bank of Communications. Dirt is gathering at their doors, and a lobby is being used as a parking area for bicycles.

No. 8 Financial St., by contrast, has a new tenant. A company called China Huarong Asset Management has put up its corporate flag and red lanterns in celebration of the Lunar New Year. While any activity on that desolate stretch should cheer those who fear a bubble, Huarong's arrival may do more to fuel their concerns than to allay them. Its mission: selling bad debt from banks. |BW|

NELSON CHING/BLOOMBERG; MAP BY DAVID FOSTER/BW

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Eggs, Bread, Milk— And a Mortgage

Retail powerhouse Tesco is planning a big move into banking now that Britain's financial giants are reeling

By Kerry Capell
LONDON

It's already the world's third-largest retailer, selling everything from groceries to gasoline at more than 4,300 stores worldwide. Now Britain's Tesco figures it can persuade the 20 million customers who visit its U.K. stores each week to add banking to their shopping lists. "We plan to bring Tesco's reputation for value for money to financial services," says Andrew Higginson, the Tesco executive overseeing the effort.

Since last spring, Tesco has opened pilot branches at six stores in England and Scotland that offer insurance, credit cards, and simple savings accounts. This year, Tesco aims to roll out more branches—Higginson won't say how many—and in 2011 expects to introduce mortgages and checking accounts. "Tesco has brand credibility and a strong focus on the consumer, which should bring some innovation to the British market," says Liz Hartley of research firm Datamonitor. She predicts Tesco will be one of Britain's top 10 banks within 5 years, with 1.5% of the market.

British banks have been battered by the financial crisis and the loss of consumer confidence it caused. Now, Chancellor of the Exchequer Alistair Darling wants new rivals to shake up the U.K.'s four giants—Barclays, HSBC, Lloyds, and Royal Bank of Scotland. After bailouts of Lloyds, RBS, and others, regulators ordered them to sell nearly 1,000 branches, creating opportunities for upstart competitors.

LIKE WAL-MART IN THE U.S., TESCO COULD FACE INCREASED OVERSIGHT IF IT GETS TOO POWERFUL

Tesco isn't the only one trying to seize the day. Others include Richard Branson's Virgin Money; Metro Bank, led by Vernon Hill, an American who built Commerce Bancorp into New Jersey's largest lender (before resigning when regulators said he awarded contracts to companies controlled by his relatives); and Home & Savings Bank, backed by U.S. private equity firm Blackstone. But only Tesco and Virgin have banking licenses, and only Tesco has 600-plus supermarkets that might serve as ready-made branches.

Tesco got its license in 2008 when it paid $1.5 billion to buy RBS out of Tesco Personal Finance. That joint venture, launched in 1997, provided 5.5 million customers with insurance, credit cards, and loans, and 500,000 with savings accounts. But most of its activity was online, and it had no physical presence in stores. Furthermore, it couldn't offer profitable products such as mortgages and checking accounts.

A big challenge for Tesco is that consumers rarely change banks. And not all the incumbents are on their knees: On Feb. 16, Barclays said net income for the second half of 2009 more than doubled, to $11.8 billion. Another worry is that like Wal-Mart Stores, which has tried and failed to break into banking in the U.S., Tesco could face greater oversight if it gets too big. It sells nearly one-third of Britain's groceries and processes 1 in every 10 credit-card transactions, but in banking, "Tesco is the underdog," Higginson says. "We are up against well-established competitors."

Higginson believes Tesco has the right mix of service and convenience to keep customers happy. He plans extended hours on evenings and weekends, and the 15 million people who hold Tesco loyalty cards give the company an extra edge. Tesco has vast amounts of data about these customers, who get points for spending at Tesco's stores. So if a customer uses her loyalty card at the gas pump, Tesco might offer her car insurance. "We have a head start," Higginson says. "It's much better to focus our marketing on people who already know and love Tesco." |BW|

–With Jon Menon and Andrew MacAskill

ANTHONY FREDA

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Deadly Business In Moscow

An American lawyer's experience underscores the lawlessness outsiders operating in Russia can face



By Tom Cahill

Jamison Firestone was at his desk when the commotion began. On the morning of June 4, 2007, the American attorney heard loud voices coming from the reception area of his law firm, Firestone Duncan, on Krasnoproletarskaya Street in Moscow. He went out to investigate and was greeted by two dozen officers from the Russian Interior Ministry.

Over the next seven hours, he says, the security forces corralled Firestone and his staff in a conference room, ransacked the offices, and confiscated computers and documents. When one of Firestone's employees objected, he was beaten so severely he required hospitalization for three weeks.

On the same day, Russian police raided the Moscow headquarters of one of Firestone's clients, the prominent foreign investment firm Hermitage Capital Management. Its founder, the American-born financier William Browder, had become a strong critic of the state-controlled energy conglomerate Gazprom and has been barred from reentering Russia since 2005. The searches of the offices marked a major escalation in Hermitage's conflict with the Russian government. And Firestone, 44, who had spent 18 years helping Western companies navigate the murky waters of Russia's legal system, knew what it could mean. "Corrupt law enforcement is the single biggest risk to business in Russia," he says. He braced for the worst.

His fears came true within months, when records confiscated during the June 2007 raids allegedly were used in an elaborate $230 million fraud that exploited three Hermitage funds to extract phony tax refunds from the Russian government. In 2008 an attorney from Firestone's firm who helped represent Hermitage was imprisoned on tax charges; he died behind bars last November after being denied medical treatment, creating a furor in Moscow. Finally, last year two unsuccessful attempts were made to steal $21 million in taxes paid to the Russian government by a company for which Firestone served as general director, he says. The people behind these attempts used his forged signature to seek rebates, a method similar to that used in the Hermitage case, he adds.

"STEALING THE COUNTRY"

Now Firestone, a former board member of the American Chamber of Commerce in Russia, has fled for London, fearing that he, too, could end up in jail. "Police [in Russia] have to stop being the Mafia," he says. "These people are stealing the country."

The alleged victimization of Browder and Hermitage is well known. In interviews with Bloomberg News, however, Firestone for the first time is alleging government-sponsored fraud aimed at him personally. His account underscores the arm-twisting and lawlessness that can afflict outsiders doing business in Russia. As widely reported, oil giants British Petroleum and Royal Dutch Shell have suffered politically backed attempts to wrest control of aspects of their Russian operations. The French carmaker Renault likewise has come under government pressure to assist a Russian manufacturer in which it had invested.

The risk of being targeted for abuse by government officials—sometimes operating in league with Russian businesses—is a central reason the country has attracted less than one-fifth the foreign investment in China and Brazil and half of what's invested in India, according to three years of data compiled by fund tracker EPFR Global.

In the wake of the death of Firestone's colleague, Sergei Magnitsky, the heads of the Moscow police's tax

CORRUPTION IS A CENTRAL REASON RUSSIA HAS ATTRACTED FAR LESS INVESTMENT THAN CHINA OR BRAZIL

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Firestone (left) has fled Moscow; Magnitsky's mother holds a photo of him

(L TO R) GRAHAM TROTT; ALEXANDER ZEMLIANICHENKO/AP PHOTO

crimes department and the city's prison division were both fired. That's not enough, says Browder, 45, who has been based in London for the past five years. "We've written well-documented complaints to the top law enforcement officers in the country that a number of police officers, judges, organized criminals, and businessmen have been involved in the theft of almost $500 million from the state and were involved in imprisoning Sergei Magnitsky," he says.

In October 2008, Magnitsky complained about the Hermitage case to Russia's State Investigative Committee, the equivalent of the U.S. Federal Bureau of Investigation. He said the officers involved in the raid on the law firm may have been linked to the Hermitage fraud, according to a transcript of his testimony.

A little more than a month later, on Nov. 24, 2008, five officers arrived at Magnitsky's home at 7 a.m. and took him in for questioning. He was accused of involvement in an alleged tax fraud perpetrated by Hermitage and was pressured to withdraw his complaint and implicate Browder, according to petitions Magnitsky filed with the Interior Ministry's Investigative Committee. "When I repeatedly rejected these propositions by the investigators pushing me to commit such a base act, the conditions of my detention become worse and worse," Magnitsky wrote in a Sept. 11, 2009, filing. Two months later, on Nov. 17, the 37-year-old father of two died from toxic shock and heart failure after being held in pretrial detention for 358 days.

Some of the records taken from Firestone's office in the 2007 raid involved an investing company called OOO Anrider. The documents showed that Anrider had paid $21.6 million in taxes in 2006, according to Firestone. A filing with Russian tax authorities dated Apr. 24, 2009, claimed that Anrider overpaid taxes by $21 million and deserved a refund. Firestone says he learned of the filing after the claim was rejected and copies of the papers were sent to him. The documents included what Firestone alleges were forgeries of his signature and Anrider's corporate seal. Someone, he says, was trying to use his identity to steal tax revenue and, in the process, possibly implicate him.

The lawyer, a native New Yorker who began studying Russian in high school and speaks it fluently, alerted tax authorities last August that the claim was bogus, documents show. The tax office didn't respond, and the police declined to open an investigation.

The Russian Interior Ministry's Investigative Committee declined to comment about Firestone or Magnitsky; it would only confirm that it is investigating Browder for alleged tax fraud. "He's screaming that they stole his companies, but he's not talking about the tax he didn't pay," spokeswoman Irina Dudukina says. "If he thinks he's innocent, then he should give evidence."

Browder, who has been placed on the Interior Ministry's wanted list, says his companies were all audited and that no tax claims have been filed against them. "They're trying to cover an enormous crime against the budget with fabricated allegations," he says.

Firestone agrees. "When you see corruption on this scale at the same time as the President is demanding investigations and cracking down, it's brazen," he says. He left his apartment in Moscow before Christmas, as if going away for the holiday, and hasn't been back. |BW|

–With Lucian Kim in Moscow

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SHE'S GOT THE WHOLE EURO IN HER HANDS

By Peter Coy

Photograph by Olivier Douliery

Germany's Angela Merkel, the EU's most powerful leader, has to save Europe from itself



Angela Merkel has no children of her own, but in the inner circles of her political party she is called Mutti—"Mom." The 55-year-old German chancellor has managed to stay in power since 2005 by governing quietly, cautiously, and pragmatically from the center right of a country that prizes smooth cooperation among big business, big labor, and big government. Although supersmart—she earned a doctorate in physics as a young woman in Communist East Germany—Merkel likes to pose as an ordinary citizen, comparing her economic policies to those of a provincial housewife who simply wants to balance the family budget. She and Germany are well suited to each other.

BLOOMBERG

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Now Merkel and Germany face a crisis, originating in dysfunctional Greece. As head of Europe's biggest economy and the country that has ladled out billions to support the European Union, she has emerged as the key player in the drive to save Greece from default, stem the bond market attacks on the euro, and instill fiscal discipline in the euro zone's weakest members. "There's no one else who can really match her power," says Roland Berger, a Merkel adviser and founder of Munich-based Roland Berger Strategy Consultants.

Yet Merkel is also hemmed in by circumstances. To understand this crisis it helps to understand the limits of the European monetary union. From the beginning, financial leaders such as European Central Bank President Jean-Claude Trichet have controlled the single currency but not the national budgets of member nations; the EU, in other words, has tools of monetary policy at its disposal but not fiscal policy. And the 1991 Maastricht Treaty, which tried to impose fiscal sanity by limiting national deficits to 3% of gross domestic product, has been routinely flouted, most egregiously by the Greeks (page 30).

STUNTED AND STUNNED

Without a clear mechanism for a bailout, Merkel says Germany won't give a single euro to Athens until Greece shows backbone and cuts its budget. German voters approve of this stance: For years they've been enduring painful industrial restructuring as well as cuts in the German welfare state; they're not in a giving mood. Germany Inc. wants Merkel to support a stable euro as well and avoid costly bailouts or loans that could seriously damage confidence in the currency. Says Josef Ackermann, CEO of Deutsche Bank: "The economic and monetary union was set up as a hard currency union, and acceptance of the euro by the German population would be seriously undermined if it were turned into a soft currency."

Germany has fought hard for a credible euro that enjoys global standing. More to the point, letting Greece's woes wreck the euro would hurt German business, which has built much of its strategy around the euro zone. "The euro has helped increase financial stability in Europe," says Jörg Schneider, chief financial officer of Munich Re, the giant reinsurer. "We've had no currency crises like we saw before."

Until now. That's why Merkel, thrifty as she is, may still have to fork out billions in German funds even if Greece manages only halting reforms. She doesn't want to cave in to the Greeks, but she also cannot afford to let the euro get so hammered by further attacks that Spain, Portugal, and Italy—the entire southern flank of the euro zone—slide into fiscal collapse as traders short their bonds the way they did Greece's. Even after the European Union pledged to support Greece, nervous investors are demanding four extra percentage points of yield to hold Greek bonds instead of safer German ones. "I don't think anybody would be extremely worried about Greece for Greece's sake. But we are all extremely worried about Greece for the euro's sake," says Kurt Lauk, president of the economic council of Merkel's party, the Christian Democratic Union.

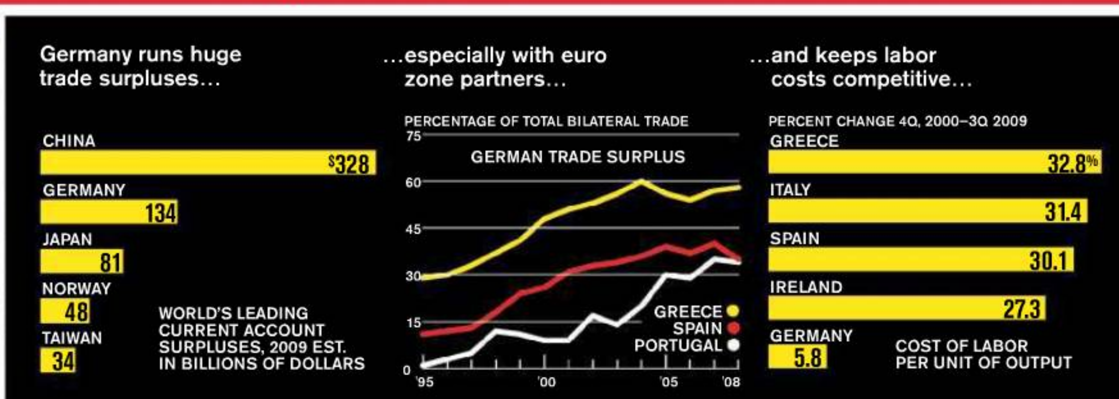

Demonstrators in Athens burn an EU flag during a public workers' strike

Not so long ago, another German chancellor, Helmut Kohl, faced a comparable but even costlier challenge: whether and how to bring the dysfunctional economy of the former East Germany, stunted and stunned by four decades of Communist rule, into political and economic union with the West. Kohl's solution—the trillion-dollar takeover called reunification—became the greatest and most controversial crusade of his life. It came to be hated by many West Germans, who

(CLOCKWISE FROM BOTTOM LEFT) SEAN GALLUP/GETTY IMAGES; SIMELA PANTZARTZI/EPA/CORBIS; CHRISTIAN CHARISIUS/REUTERS/CORBIS; CHARTS BY STANFORD KAY

THE NUMBERS BEHIND THE SQUEEZE ON GERMANY





Data: Moody's Investors Service, Eurostat, Organization for Economic Cooperation & Development, Bank for International Settlements, Europea

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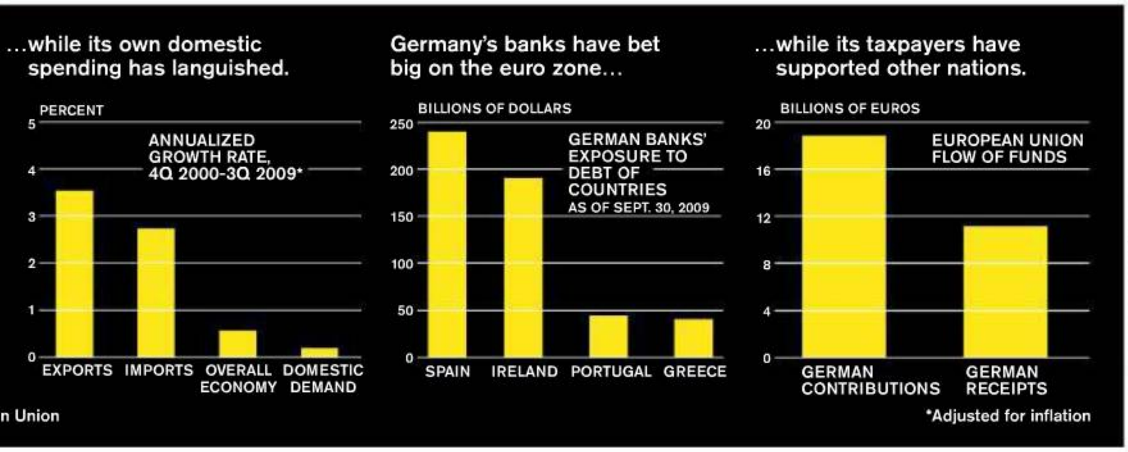
Germany would not have to pay all of that, but its share would be bigger than any other country's if such a rescue occurred.

Adding to the strain is a second problem that has received much less attention—the unstable imbalance between rich, export-dependent Germany and the indebted European countries that buy its goods, take its loans, and host its factories. That's not just Greece, but Spain, Portugal, Ireland, and Italy as well. If the intra-European imbalance isn't dealt with, the entire euro zone will be subject to even greater stresses. For Germany, in other words, the status quo that has been so profitable for so long is becoming perilous.

Since World War II, Germans have successfully studied, saved, invested, and sold high-quality goods to the rest of the world. BASF, Bayer, Bosch, Daimler, Infineon, Miele, Siemens, SAP, ThyssenKrupp, and Volkswagen are just some of Germany Inc.'s marquee exporters. The Germans have sacrificed plenty to extend their success. When the nation joined the euro zone in 1999, unemployment was over 10% and the country was locked into monetary union at a time when the deutsche mark was overvalued. So Germany boosted productivity and clamped down on wage growth. "In effect they did a devaluation by improving their competitive situation," says André Sapir, a senior fellow at Bruegel, a Brussels-based think tank. Even as the euro strengthened against the dollar and the pound, German exports rose 65% from 2000 to 2008.

resented its inefficiencies and costs, but eventually, fitfully, painfully, it worked. Eastern Germany came back to life; Kohl's vision knitted together East and West. Today, one of the people who embodies Kohl's achievement is the child of East Germany who became his protégé and successor: Angela Merkel.

If Merkel were to try to save southern Europe the way Kohl saved the East, her task would be no less arduous and only somewhat less expensive than his. To relieve the market's fears about Greece and the other fiscally feeble euro zone countries would require the EU to pledge more than $400 billion in potential aid, according to a report by French bank BNP Paribas.





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THE GREEK CRISIS: MERKEL'S OPTIONS



Greek workers protest a government freeze on salaries and higher taxes

As leader of the effort to defuse the threat that Greece's runaway debt poses to the euro, the German chancellor has few if any good choices. They are:

LET GREECE SINK

Leave the Greeks to right their budget on their own, or slide into default if they can't.

PROS: This move would score big points among German voters.

CONS: It could knock the euro down even more as bond traders attack other weak countries in the euro zone with renewed vigor.

The trouble is that Germany's trading partners in the euro zone, which buy 43% of its exports, can't improve their competitiveness against the country by depreciating their currencies, the traditional remedy. In essence, by locking themselves into the euro, Germany's exporters have a currency that works very much in their favor. Greeks and Spaniards want German goods and don't have to pay in devalued drachmas and pesos to get them. The euro provides German companies other advantages as well. Says Frank Asbeck, chief executive of Bonn-based SolarWorld, a major maker of solar products: "We do two-thirds of our business in euro land. The currency makes things easier—no hedging, it's transparent, the business formalities are the same."

If Germany still had its old currency, the deutsche mark would doubtless be stronger than it is now, crimping its competitiveness against other European states. So inside Europe, Germany is in effect working with a currency that is undervalued and thus supercompetitive. That makes the country a lot like China, which has kept its exports cheap by pegging its currency to the dollar against the wishes of the American government. Last year, Germany's surplus on its current account—the broadest measure of goods and services—was 5% of GDP.

But the Greek crisis has exposed a flaw in Germany's business model. Seduced by membership in the euro zone, many of the country's trading partners overborrowed and overspent in the boom times. High inflation made their wages and products less and less competitive, especially against Germany. They can no longer afford to buy all those products without the ability to make some money selling something back to the Germans, or at least generating more exports in general. Their foreign debts—a reflection of the deficits they've been running—have been growing to unsustainable heights. They need more balanced trade. And so does Germany, which would be healthier if its citizens consumed more and relied less on exports for growth. "It's a pathology. The Germans are way too far in surplus," says Gary Herrigel, a University of Chicago political scientist specializing in Germany.

Clearly, something has to give. But what? In a Feb. 17 column in *The Financial Times*, Harvard University economist Martin Feldstein called for temporarily bringing back the drachma, letting Greece float its currency and set its own debt and interest-rate policies. But that option isn't on the table because it could lead to the breakup of the euro zone and the end of the decades-long movement toward European unification. Most Germans remain committed to being good Europeans, in part as penance for having plunged the Continent into two world wars in the 20th century.

If Germany's trading partners can't depreciate their currencies, they can only regain competitiveness quickly by lowering workers' pay. But that's disastrous for countries like Greece, where workers have taken on big debts, because it means employees have to pay back their loans with shrinking paychecks. The mix of debt and joblessness could trigger a downward spiral of defaults, bankruptcies, and bank failures. That would be lethal for the likes of Greece, and no good for Germany, either, because its companies need viable customers.

"INCOMPATIBLE VALUES"

The alternative path for Merkel—call it the Kohl road—is bound to be unpopular at home. And its chances of success are far from assured. It would require Germany to ease the pressure on its trading partners by giving them more loans and outright aid while simultaneously buying more of their products to help those countries earn their way back to good health. Of course, Germany has been doling out money to poorer European nations for years, but many economists say it needs to go even further. "For their good fortune, they

CORENTIN FOHLEN/SIPA PRESS

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SAVE GREECE

After a month or so to cool the markets and give the Greeks a chance to make cuts, extend German or Franco-German aid to Athens.

PROS: It would patch up the euro.

CONS: Given the Greeks' track record on spending, the chances of long-term fiscal probity are low—which means another crisis would be inevitable, unless Germany plays the heavy and insists on close monitoring.

PHONE UP THE IMF

The International Monetary Fund knows how to straighten out a wayward country's finances and is used to being attacked for its stinginess.

PROS: The IMF would probably get the job done, and Germany would not be blamed for the pain inflicted.

CONS: The EU could balk at the idea, since an IMF bailout would signal that Europe can't take care of its own. And French President Sarkozy isn't keen on publicity for the IMF chief, a French political rival.

should share the wealth," says Adam S. Posen, a senior fellow at the Peterson Institute for International Economics in Washington. (Posen is also a member of the Bank of England's rate-setting Monetary Policy Committee and said his remarks are personal opinions, not British policy.)

This prescription raises a question: Can Spain, Greece, and the rest of the southern tier provide the goods and services, from Italian design to Greek island getaways, that Germans want to buy? Can these economies learn to innovate? Spain showed signs of doing so, but something, possibly bubble fever, slowly choked off its dynamism. Change won't come quickly, but if there is no change at all, these imbalances will only get worse. And they will slowly tear the euro zone apart.

Just as Kohl saved the East and then spearheaded the effort to introduce the euro, Merkel could aid the southern European countries now, continuing Kohl's tradition of enlightened self-interest. Geopolitically, Germany cannot be strong if the rest of the Continent is weak, Marko Papic and Peter Zeihan, analysts for Stratfor global consultants, said in a Feb. 8 opinion piece. "The only way for Germany to matter is if Europe as a whole matters," they wrote.

Not surprisingly, Germans resent being asked to open their wallets to Greeks who, in their view, behaved irresponsibly and lived beyond their means. "I know the mentalities of the southern European countries very well, and I know exactly how they think and what concept of the world their thinking is based on. These are incompatible values," says Anton Boerner, head of Germany's BGA wholesale and export federation. "You don't get this into the heads of southern Europe's population."

Boerner may condescend, but he has a point. The Greeks, in particular, brought this mess upon themselves. Nevertheless, helping Greece and other stressed countries keep their economies intact and avoid debt-deflation spirals could be what's required to avoid a Continental meltdown. John Maynard Keynes, the British economist who diagnosed the Great Depression, argued that in a steep downturn, trade deficit countries aren't capable of bearing all the costs of correcting imbalances—trade surplus nations must share the burden. Another student of the Depression, American economic historian Charles P. Kindleberger, argued that free trade depends on an anchor country that's willing to be an importer and lender of last resort in a crisis. In this case, that would be Germany.

GERMANY COMES FIRST

Merkel shows few signs of Keynesianism. She's taking a hard line with Greece. As for boldly reshaping Germany so it consumes more imports, that's not in her talking points either. Last October, a month after winning reelection as chancellor, she told a labor convention in Hanover that "Germany's strength lies largely in the fact that the Federal Republic is a center of industry and that it's an export nation." Lest there be any doubt, Merkel added: "All those who now say we've depended too much on exports are undermining our biggest source of prosperity and must be rebuffed."

For Germany to lead Europe out of its slump would require heavier deficit spending to stimulate the country's economy and suck in imports. Merkel's government expects the budget deficit to swell to 5.5% of GDP this year, almost double the 3% ceiling technically required of euro zone members. Although Germany could easily afford a spurt of further stimulus given its rock-solid AAA rating, Merkel has been heading in the other direction, seeking greater fiscal probity. That, too, goes over well with the aging German populace, which is piling up wealth for retirement. The chancellor pushed for last year's constitutional amendment restricting Germany's structural budget deficit to just 0.35% of GDP, which requires her to start shrinking the budget gap in 2011.

HELPING GREECE AND OTHER STRESSED COUNTRIES KEEP THEIR ECONOMIES INTACT COULD BE WHAT'S REQUIRED TO AVOID A CONTINENTAL MELTDOWN

In other words, Merkel may have the whole euro zone in her hands, but it's not at all clear she welcomes the responsibility. "Merkel is being forced by events in the Greek crisis," says Fredrik Erixon, director of the European Centre for International Political Economy in Brussels. "In such a situation you can't do medium- or long-term planning. You just try to arrest the source of what's causing unrest in markets."

Merkel's reluctance to stretch Germany's balance sheet so European growth can be propped up may stem in part from her own history. She was born after the Nazi era and "views Europe less emotionally" than her mentor, former Chan-

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cellor Kohl, says Gerd Langguth, a Merkel biographer and political scientist at the University of Bonn. Adds Roland Berger: "She's not burdened by history. She's simply pragmatic. She knows what she wants and thinks what she does is in the interests of Germany and Europe. She is a European, yes, but Germany comes first."

Merkel's woman-of-the-people approach is what helped her win a second four-year term as chancellor in September. She and her husband, Joachim Sauer—a quantum chemist at Berlin's Humboldt University—are both in their second marriages after divorces. "Merkel comes across as utterly normal, and the average German can really relate to her," said Carl Graf von Hohenthal, a management adviser at the Brunswick Group and former deputy editor-in-chief of Germany's *Die Welt* newspaper, who has known her since 1990. "She dresses well but doesn't wear overly expensive clothes." Merkel wheels a shopping cart through her local food store, trailed by her security detail, at least once a month. She even bags her own groceries. "She doesn't smoke, she doesn't drink much—power is her thing," said Friedrich Thelen, former parliamentary

GOLDMAN STARS IN THIS GREEK TRAGEDY

The firm's currency and bond deals for Greece have drawn fire

By Elisa Martinuzzi

Goldman Sachs, Wall Street's most profitable securities firm and a boon to conspiracy theorists the world over, has angered EU regulators over its role as Greece's enabler—helping the Greek government mask the severity of its debt problems early last decade. Goldman designed an off-balance-sheet currency swap deal that delivered a windfall to the Greeks shortly after they entered the euro zone.

Now there's evidence Goldman may have also misled investors when it managed the sale of $15 billion worth of Greek bonds in subsequent years, according to a review of bond prospectuses by Bloomberg News. No mention was made of the Greek currency swap in sales documents for the bond offerings in at least 6 of the 10 sales the bank arranged for since the 2002 currency transaction.

Failing to disclose the swap may have allowed Greece, Goldman (a co-lead manager on many of the sales), and other underwriters to get a better price for the securities, says Bill Blain, co-head of fixed income at Matrix Corporate Capital, a London-based broker and fund manager. Goldman has earned about $24 million underwriting the bonds since 2002.

That year, Goldman helped Greece pull off a lucrative cross-currency swap in which some $10 billion in Greek debt, issued in dollars and yen to international investors, was swapped for euro debt using a "historical" (and very favorable) exchange rate, says Christoforos Sardelis, then head of Greece's Public Debt Management Agency. (Greece entered the euro zone at the start of 2001.) The swaps used by Greece to manage debt were "at the time legal," Greek Finance Minister George Papaconstantinou said on Feb. 15, adding the government doesn't use such swaps now.

Athens got far more money than it would have at the prevailing exchange rates for the euro back in 2002. Further, the currency deal didn't show up in official debt statistics—and did not affect the debt-to-GDP limits for countries in the euro zone. Goldman also extended a $1 billion up-front payment to Athens as part of the deal.

This complex transaction was until recently news to EU regulators, who last week launched an investigation into the Greek currency swap. Goldman could face legal liability "if it could be established that they were knowingly hiding risk, and therefore knew or had reason to know that the bond disclosure documents were misleading," says Thomas Hazen, a law professor at the University of North Carolina at Chapel Hill. "But that would be a tough hill to climb, in terms of burden of proof. There would have to be some sort of smoking-gun memo." Michael DuVally, a spokesman at Goldman Sachs in New York, declined to comment.

Legal niceties aside, Goldman's image in Europe may take yet another hit. "The price of bonds should reflect the reality of Greece's finances," Blain says. "If a bank was selling them to investors on the basis of publicly available information, and they were aware that information was incorrect, then investors have been fooled."

—With Maria Petrakis in Athens, Aaron Kirchfeld in Frankfurt, Ilias Antoniou in London, and David Scheer in New York





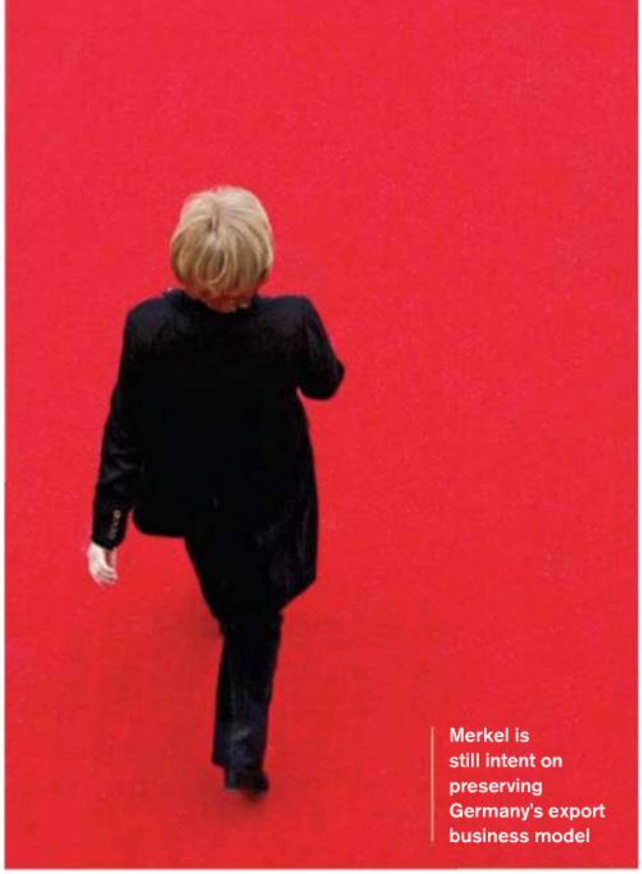
Finance Minister Papaconstantinou (top) and Goldman CEO Blankfein

(TOP TO BOTTOM) JASON ALDEN/BLOOMBERG; RAMIN TALAIE/CORBIS

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editor of the business magazine *Wirtschaftswoche* and founder of Thelen-Consult, a Berlin-based business advisory group.

If power really is her thing, then Merkel knows that retaining it depends on keeping business happy. And while German taxpayers gripe about bailing out Greece, German companies are more sensitive to the losses they would suffer if Greece and other European nations slipped under. Case in point: Merck KGaA in October said unpaid receivables from Greek hospitals had surpassed 50 million euros, calling the unpaid debts a "very serious situation" that could affect margins in its drugs division. Some of Germany's biggest companies, such as automakers Daimler, BMW, and Volkswagen, or infrastructure equipment maker Siemens, sell their goods all over the world, so their fates aren't tied up in any one region. But the crucial small and midsize manufacturers, the *Mittelstand*, are very dependent on the health of the European market and want to see it keep growing.



Merkel is still intent on preserving Germany's export business model

FABRIZIO BENSCH/REUTERS

German banks, too, are highly exposed to the risk of rising defaults. Hypo Real Estate Holding, nationalized by the German government during the financial crisis, has a large exposure to the sovereign debt of Portugal, Ireland, Italy, Greece, and Spain. Hypo Real Estate has some $5 billion in Greek public debt alone.

All of these problems are complicated by an unanticipated lapse in the economic recovery of Germany and Europe. In the last three months of 2009, German economic activity was flat and the euro zone grew at an annual rate of just 0.1%. Slow or nil economic growth makes Germans even more reluctant to extend aid to others. If the slowdown is bad for Germany, it's devastating for Greece, which is being asked to cut government spending at the same time that its economy is contracting—the opposite of the Keynesian prescription for recovery.

PLENTY OF CREDIBILITY

If Merkel does embrace a bigger role for Germany in the economic recovery of Europe, it will be because she has been persuaded that it's in the long-term interest of Germany to make its export markets healthy and stable again. The first step for Merkel would be to speak out more clearly on Greece. "We're past the point where constructive ambiguity is constructive," says the Peterson Institute's Posen. "It's not like you're going to scare the Greeks into behaving any different." Opponents of aid say that bailing out Greece would encourage future misbehavior by it and others. The solution to that so-called moral hazard is to make the conditions so onerous and the monitoring so intensive that no other country would be tempted by it.

Beyond that, Merkel could offer up a vision of a Germany that no longer depends on a business model of extracting its growth from abroad. History tells us that one way or another, Germany is going to have to open its wallet to end this crisis, as it has so often in the past. But simply handing out money won't fix the imbalances that caused the crisis. For years, skeptics in the U.S. and Britain have argued that the euro experiment was doomed to fail. Now even true believers are concerned that something must be done, and soon, to relieve the mounting stresses on the system. "A common currency is right for Europe. It is the ideas behind the euro regime which are rotten and dangerous," German economist Jörg Bibow, who teaches at New York's Skidmore College, wrote last year.

Merkel has built up credibility to burn as a defender of German interests. Germans know their "Mutti" is watching out for them. That puts her in the best position of anyone to tell the German people that the old ways aren't working anymore, and Germany must change. Her former boss had the guts to say that to his people. Will she? |BW|

—With Carol Matlack in Paris and Rainer Buergin, Tony Czuczka, Leon Mangasarian, and Brian Parkin in Berlin

Business Exchange

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Euro Trap

Some people say Greece should abandon the euro. Yet in a 2007 commentary, University of California at Berkeley economist Barry Eichengreen said that exiting the monetary union would be a procedural nightmare. Virtually any contract—including those governing employment, mortgages, and bonds—would have to be redenominated in the domestic currency. Everything from parking meters to vending machines would have to be replaced or modified.

To read the commentary, go to **http://bx.businessweek.com/european-financial-crisis/reference/**

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Blue Nile's Irvine, eBay's Donahoe, Molson Coors' Swinburn, and T. Rowe Price's Kennedy all lived to tell the tale

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SURVIVOR: CEO EDITION

How four rookie CEOs were tested on the most treacherous business battlefield in decades

By Douglas MacMillan

Timing, as comics say, is everything. So what do you do when it's your first time on stage, and you're getting killed up there, with the audience booing and heckling and calling for the hook? Ask John Donahoe, who became the CEO of eBay in March 2008. Not only did Donahoe take the reins of the online retailer from one of the star CEOs of the dot-com era—the current California gubernatorial hopeful Meg Whitman—he did so at a time when the U.S. economy was imploding and eBay's business model was under assault. Suddenly, the new guy was getting pounded from all sides. One employee wrote an online post arguing that "Donahoe has made eBay a miserable debacle and it's getting worse every day." The owner of a company that sells on the auction site called his strategy a "concentrated effort to destroy the eBay marketplace." Jim Cramer weighed in on his *Mad Money* television show with this vote of confidence: "EBay has lost touch with reality ... the company is hapless," he said in September 2008. "They ought to sell themselves to someone." You might call it CEO hell, but Donahoe didn't kid himself. "It's going to get worse before it gets better," he kept saying.

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While the Great Recession was tough on just about everyone, rookie CEOs were faced with what will likely be the biggest crisis of their careers. Employees, investors, and board members looked to them for guidance, but their task was complicated by swooning stock prices and, often, mass layoffs. "It's easy to look like a great leader when everything is going well," says executive coach Marshall Goldsmith. "The real great leader shows up in hard times."

Not all the newly minted chief executives made it through the flames. Frederick A. "Fritz" Henderson stepped down in December after eight months in the top job at General Motors as the automaker continued to struggle. Owen Van Natta lost his CEO spot at the social networking site MySpace on Feb. 10, after nine months. A record-high 1,482 chief executives resigned, retired, or stepped down from public and private U.S. companies in 2008, according to Challenger, Gray & Christmas, which helps laid-off executives find work. An additional 1,227 left their jobs in 2009.

The latest recession was particularly treacherous because it was so broad, hitting Wall Street, Detroit, the housing industry, and other pillars of the economy. Yet the challenges in particular sectors may have been more severe in the past—say, in the tech industry after the dot-com bust or in manufacturing during the oil crisis of the 1970s. Robert Crandall got his first chief executive job at American Airlines just in time for the tumult of airline deregulation and oil price swings in the 1980s. "Desperation is the mother of invention," says Crandall, who is now retired. To compete with new low-cost rivals, he came up with the first national frequent-flier program and a two-tiered labor system. "Sure, it seemed challenging," he says. "But on the other hand, [becoming CEO] was the thing that I had been trying to achieve for many years."

Rookie chiefs from downturns past say starting the job in crisis forever affects how you lead. Ron Sargent was named to the top job at office-supplies retailer Staples the week before the September 11 attacks and in the midst of recession. "The thing that changed in me was the willingness to make tough decisions quickly," he says. After the terrorist attacks, Sargent had to choose between cutting payroll or trimming product lines to save money. He speedily worked out a back-to-basics strategy that eliminated consumer-oriented products like Britney Spears backpacks. It hurt margins in the short term, but it saved jobs and helped keep customer service strong.

First-timers from this recession such as Donahoe and T. Rowe Price's James A.C. Kennedy agreed to talk about how they managed through the downturn and about what they learned. Among the lessons seared into their hides was this one: Resist the inclination to hunker



JOHN DONAHOE
eBay

AGE 49

CEO SINCE March 2008

PREVIOUS ROLE President of eBay Marketplaces

TRIUMPHS Completed a pair of billion-dollar acquisitions at a time when competitors' purse strings were tight; sold Skype to private investors to boost profits

TO-DO Win back online shoppers who've defected to sites like Amazon and Craigslist

LESSON You're not running for Mr. Popularity

FAMOUS FIRST IMPRESSIONS

Rookies are tested in the executive suite and beyond. A few remarkable debuts–and failures–through modern history:

PHENOMS



ORSON WELLES
1941
His first Hollywood film was the masterpiece *Citizen Kane.*

WILT CHAMBERLAIN
1959-60
In his first season, "Wilt The Stilt" was named the league's most valuable player and averaged 37 points a game, more than any rookie ever.

HARPER LEE
1960
A former airline reservation clerk in New York, Lee took a year off to write her first novel: *To Kill a Mockingbird.*

DAN MARINO
1983
Drafted as a backup for the Dolphins, Marino ended up leading his conference in passing and starting in the Pro Bowl, the first rookie to do either.

BOB CRANDALL
1985-98
CEO Crandall guided American Airlines through airline deregulation, instituting the first national frequent-flier program and dual-class labor system.

FLOPS

HERBERT HOOVER
1929-1933
Sworn in seven months before the stock market crash of Black Tuesday, the 31st President is remembered for the "Hooverville" shanty towns.

JOHN SCULLEY
1983-1993
After Sculley was recruited to run Apple, the company fired Steve Jobs and headed into a long slide.

SAM BOWIE
1984
The NBA center, drafted second overall, had the misfortune of a mediocre career after getting picked ahead of six-time champion Michael Jordan.

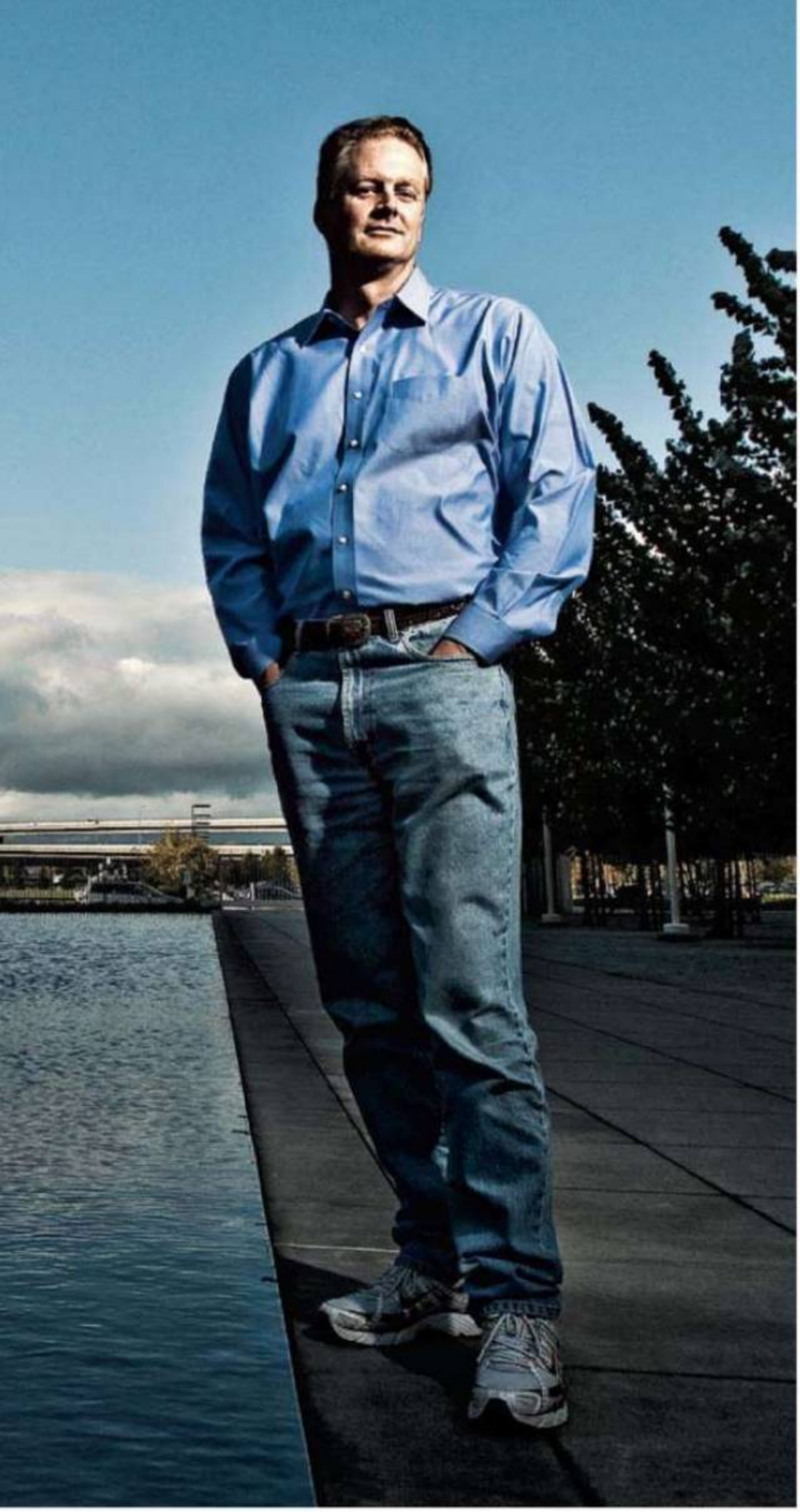
JERRY YANG
2007-2008
Yahoo's co-founder was vilified by shareholders for rebuffing a $44 billion acquisition offer from Microsoft and quickly gave up the CEO job.

CONAN O'BRIEN
2009-2010
As he was bounced for Jay Leno, O'Brien said it was "always my dream to host *The Tonight Show*—for seven months."



(PREVIOUS PAGE, L TO R) BRIAN SMALE; ERIC MILLETTE; JAMIE KRIPKE; STEPHEN VOSS;
(THIS PAGE, CLOCKWISE FROM LEFT) SUNSET BOULEVARD/CORBIS; ERIC MILLETTE; PAUL DRINKWATER/NBCU PHOTO BANK /AP PHOTO

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SERVANT LEADERSHIP

Donahoe's early months as eBay CEO incited such widespread vitriol in large part because he picked a path that was far different from that of Whitman. Coming into the job after three years at the San Jose company, he carried out the first round of layoffs ever at eBay. He reorganized the company's Web site in a way that gave less visibility to some small sellers, long eBay's bread and butter. And he cut a deal to acquire a consumer credit business called Bill Me Later for $945 million in the middle of the credit crunch, sending eBay's stock downward.

Although Donahoe had led the privately held Bain & Co. consulting firm before moving to eBay, he says running his first public company, with so many constituencies, required a different approach. It's not a popularity contest: You do what you think is right for the company and resist the attacks from those who prefer the status quo. "When I became CEO, there was an opportunity to take the next step," says Donahoe, 49. "And the next step was making changes that we knew were going to be unpopular in the short term." Donahoe, in fact, found that many employees and investors were more open to dramatic change than they might have been otherwise. "In a crisis, people were scared enough and uncertain enough that I could take action," he says.

Donahoe is winning over at least some of his critics now. After falling below 12 at the end of 2008, eBay's stock has risen to 23. The company is earning steady profits again, and analysts say eBay is better positioned to compete with fast-growing rivals such as Craigslist and Amazon.com. "Donahoe has done a good job of getting [eBay] back on track," says analyst Colin Sebastian of Lazard Capital Markets.

Donahoe's strategy is born of an approach he calls "servant leadership." He thinks of eBay's customers first, specifically the companies and entrepreneurs who sell goods on the site. Then he visualizes a chain of command through which the CEO can deliver what customers need. On trips around the world he takes along a Flip Video camera and films interviews with eBay sellers to share their opinions with his staff. He has even tied managers' compensation to customer loyalty, measured through regular surveys.

Far from resenting the tough circumstances of his first job atop a large public company, Donahoe calls the experience a gift. "I will be such a better leader having gone through that, vs. having had a lot of early success," he says.

down and wait out the troubles. Remaining proactive and decisive improved their competitive positions as the economy began to recover. John Thompson, vice-chairman of the headhunting firm Heidrick & Struggles, says it's particularly important in a downturn for CEOs "to bring an extraordinary sense of urgency."

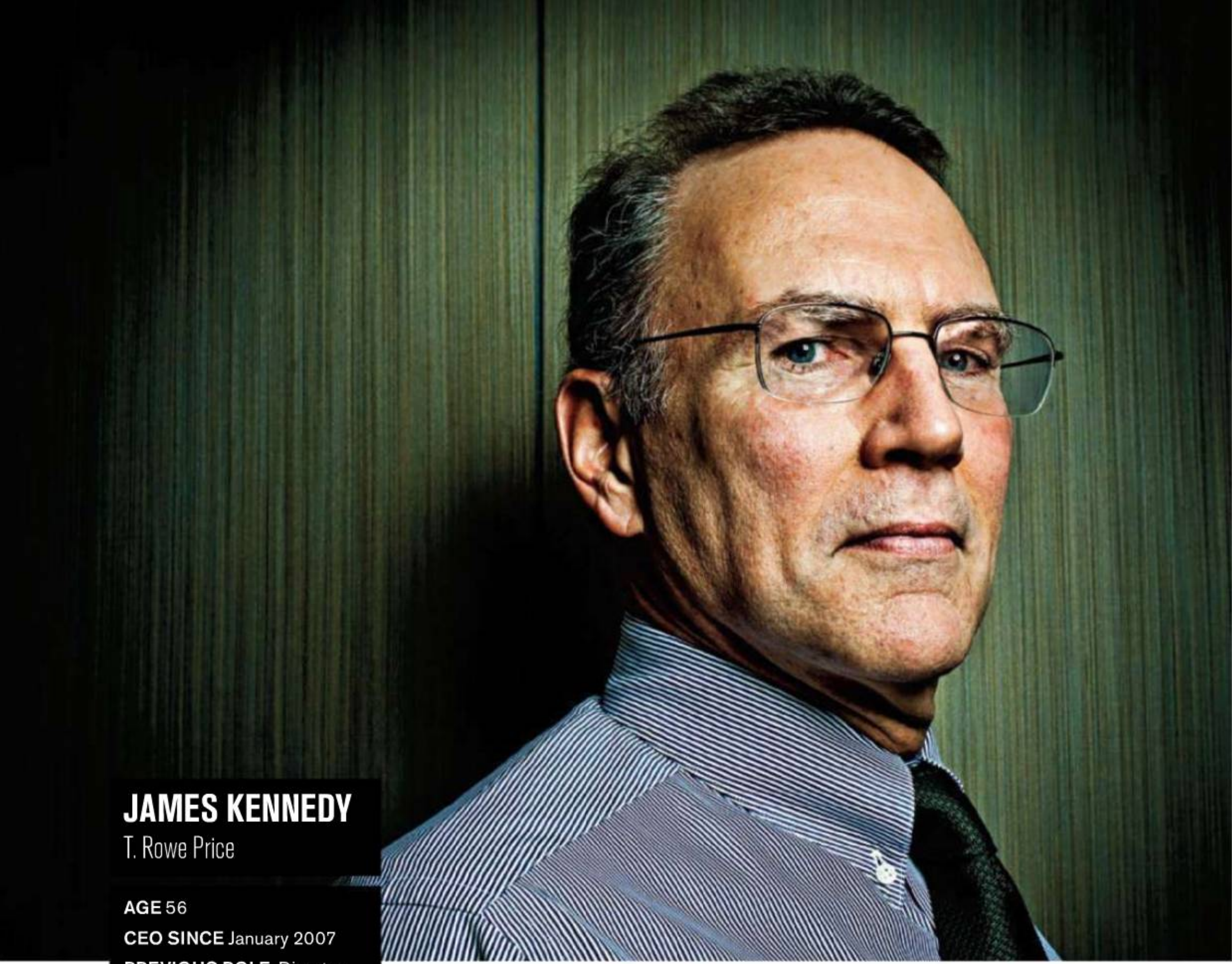
Many of the new CEOs solicited counsel from veteran leaders; Donahoe consulted with Cisco Systems' John T. Chambers. Yet leaders know they bear sole responsibility for the decisions they make. "At the end of the day the CEO has to pick a path and take it," says Jeffrey A. Stoops, chief executive of the wireless phone tower company SBA Communications.

SWIMMING TO CONFIDENCE

T. Rowe Price's Kennedy prides himself on balancing the demands of office and home. But over the second weekend of September 2008, as Lehman Brothers was crumbling to dust, he worked the phones from his Baltimore headquarters, trying to ease investor concerns about his own firm. Family, church, and gym all had to wait. "I think God might forgive me for missing Mass that one day," says Kennedy, 56.

Promoted to the top post at T. Rowe Price in January 2007, Kennedy had a seat precariously close to the biggest financial

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STEPHEN VOSS

JAMES KENNEDY

T. Rowe Price

AGE 56

CEO SINCE January 2007

PREVIOUS ROLE Director of Equities

TRIUMPHS Kept up the confidence of investors through the collapse of Lehman Brothers; made time for the lap pool, Sunday Mass, and a second marriage

TO-DO Get a piece of the hot exchange-traded-fund market

LESSON The boss that keeps cool helps employees stay calm and productive, too

meltdown since the Great Depression. His firm is the sixth-largest mutual fund manager in the U.S., with more than $350 billion in assets under management. "The world seemed to be collapsing around us," he says of his first two years. All the while he was trying to learn to cope with the demands of a challenging new role in an organization where he had worked for more than three decades.

That meant learning new areas of the business. When Kennedy was named CEO, he left the equities department he had been running to set up shop on the fixed-income floor. His timing was fortunate: Fixed-income analysts were just starting to spot the dangers of mortgage-backed securities in mid-2007. Alarmed by the "ugly" possibilities, the new CEO ratcheted back on growth and trimmed expenses, such as hiring, advertising, and IT. "He's been diligent in terms of cost and risk," says Daniel Fannon, research analyst with Jefferies.

When Lehman Brothers filed for bankruptcy on a Monday morning in September 2008, Kennedy's strategy looked prescient. T. Rowe Price had steered clear of many of the complex financial instruments that blew up in the aftermath. Profits dipped to a 12-year low that December, but the firm bounced back faster than almost all of its peers, in part because of Kennedy's preemptive cost-cutting. In 2009, T. Rowe Price's assets under management increased 41%, to $391.3 billion, compared with a 16% rise for U.S. mutual funds overall, according to research firm Strategic Insights. And unlike many peers, the asset manager is coming out of the downturn "with a very clean brand, a very good image," says analyst Fannon.

Kennedy made time for his personal life throughout the challenging months. He got married last year, for the second time, and kept up regular golf games with his new wife, Maureen. He also swam laps three times a week. Periodic checkups with his executive coach, Marty Seldman, helped Kennedy keep perspective on his life and career. "If leaders look like they are unraveling, it can create a vicious cycle of

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more fear and more stress in the company," says Seldman. "Jim stayed calm and confident."

Looking back, Kennedy sounds as grateful to have safeguarded his own health as much as his company's. "For some CEOs, this would shorten their careers pretty dramatically," he says. "Others will learn from this and be impacted for the rest of their lives."

DIAMONDS ARE FOREVER

Diane M. Irvine had no time to celebrate getting the chief executive job at online jewelry retailer Blue Nile. Hours after her appointment in February 2008 she had to tell investors that sales from the previous holiday season had been worse than expected—and the credit crunch would probably mean a dreadful next year. The company's shares sank 20% the next day. "It was very daunting," she says.

Irvine had to come up with a plan, and fast. She surprised many by using the recession as an excuse to go on the offensive. "We can gain market share," she told investors during a March 2008 presentation. She argued that Blue Nile had an edge on brick-and-mortar jewelry brands like Tiffany's and Zales in a downturn because it required little overhead and virtually no inventory. Competitors would struggle and close stores; Blue Nile would invest and expand.

The strategy had its doubters. Analysts such as Imran Khan of JPMorgan Chase had lowered their estimates in February of that year and saw little reason for optimism after Irvine announced her plans. "We were selling luxury goods in what was probably the worst economy in 75 years, so I think there was tremendous skepticism about how the company would weather the storm," says Mark Vadon, who founded Blue Nile in 1999 and led the company until Irvine took over. Adding to the challenge of waning consumer demand were diamond prices, which remained at boom-year levels.

Irvine doubled down on technology that would help bring in new customers. Blue Nile's site underwent a year-long revamp, adding new tools to help buyers search for diamonds by budget, shape, and quality. The new CEO also pushed into overseas markets, tweaking the Web site to accept 23 different forms of currency.

Credit was a barrier to many potential sales. So the Seattle company joined up with Bill Me Later (the company eBay would later acquire) to offer customers no-interest financing for six months on large purchases.

Although Irvine, now 51, worked as chief financial officer at the company almost since its founding, her button-down demeanor as CEO has been a turnaround from the blue-jeans vibe of founder Vadon, 11 years her junior. "She added discipline to that company from the day she walked through the door," says Scott Devitt, analyst at Morgan Stanley. It's a work ethic Irvine says she developed in her youth, growing up on a farm and working summer jobs in the cornfields of Illinois.

Irvine's offensive is beginning to pay off. In October, Blue Nile posted its first year-over-year growth in revenues since mid-2008. Fourth-quarter revenues also increased, by 20%, although profits missed Wall Street forecasts. The company's stock, which had tumbled to less than 20 a year ago, is now trading at 49. "She's done a great job of stabilizing the business," says Deutsche Bank analyst Herman Leung. Meanwhile, three of the top traditional jewelry retailers have filed for bankruptcy, and competitor Zale appears poised for a major restructuring.

Having made good on her initial promises to investors, Irvine feels assured the hardest part of becoming a chief executive is over. Her only regret? She's all on her own in the corner office. "You don't have that set of peers anymore," she says.

DIANE IRVINE
Blue Nile

AGE 51

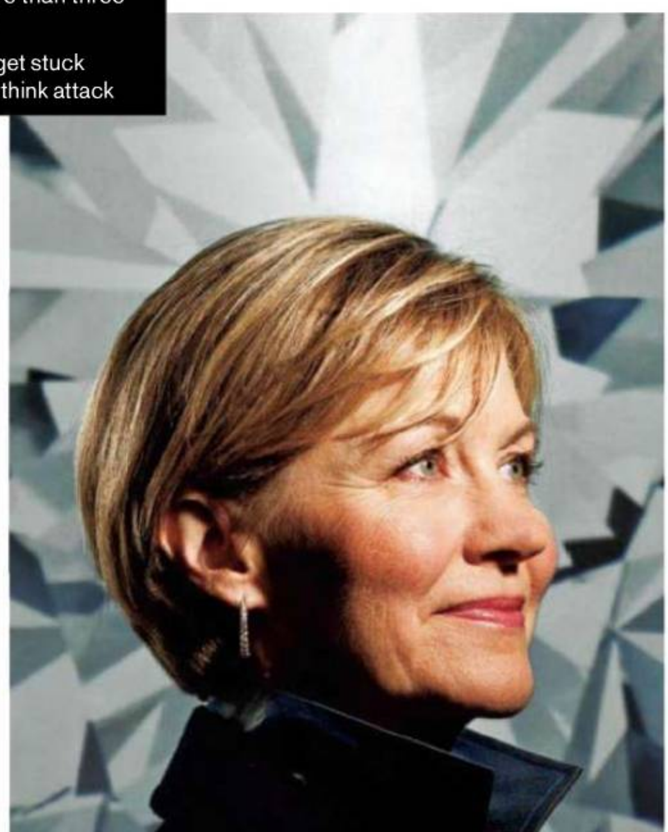
CEO SINCE February 2008

PREVIOUS ROLE President and Chief Financial Officer

TRIUMPHS Took market share from brick-and-mortar rivals through aggressive growth; overhauled a stuffy Web site

TO-DO Learn how to sell diamonds in more than three dozen countries

LESSON Don't get stuck playing defense; think attack



BRIAN SMALE

YAMMERING IS GOOD

Molson Dry. Coors Light. Miller Genuine Draft. Carling. Just reading all the beer brands sold by Molson Coors could make you tipsy. The company, jointly headquartered in Denver and Montreal, has grown into one of the world's largest brewers through a series of 10 acquisitions and joint ventures over the past decade. Yet all the deal activity left a mishmash of workforces when Peter Swinburn became head of the company in June 2008. So even as

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JAMIE KRIPKE

PETER SWINBURN
Molson Coors

AGE 57

CEO SINCE June 2008

PREVIOUS ROLE President and CEO of Coors

TRIUMPHS Built a cohesive global workforce out of thousands of people from different companies; increased employee satisfaction and output during tough times

TO-DO Spot opportunities for further expansion

LESSON Use crisis to forge a stronger team

sales began to slide going into the downturn, he decided his priority would be forging a cohesive corporate culture. "If you spend five years developing a brand, why shouldn't you spend five years developing a culture?" asks Swinburn, 57.

The challenge was getting a staff of 15,000 workers on three continents to think as one. There were different languages and work practices. The U.S. and British operations even disagreed over the proper size for a beer barrel. (It was 117 liters in the U.S. and 163 in the U.K.) "You had people who were focused on their individual businesses and their own regions," says Rob Borland, a top marketing executive.

Swinburn spent his first six months as CEO sketching out a framework for the new approach. In conversations with senior executives and in town hall meetings with employees, he came up with an unofficial motto—"Challenge the expected"—that he hoped would entice employees at all levels to think outside their roles. Swinburn also made sure employees had better tools to interact with one another. On the suggestion of one worker, he signed the company up for Yammer, a site for short messages similar to Twitter that would be visible only to colleagues. Some 2,000 employees now utilize the site to provide updates and collaborate on projects. Denver-based IT staffer Miguel Zlot recently used the site to communicate with colleagues from afar while working on a Web project. "We needed to grasp ahold of something common," he says.

Employees are also getting together in person more frequently. Benoit Maillette, the brewery manager in Toronto, says he meets with counterparts from around the world once or twice a year to socialize and share business ideas. One January gathering was in the company suite at a Montreal Canadiens hockey game, with a lot of time "around the bar," says Maillette. Swinburn's efforts appear to be having an impact. The employee research firm Towers Watson says that in independent surveys, 87% of Molson Coors employees said the company had a "clear vision for the future" in 2009, up from 73% in 2008. The average for global high performers surveyed by Towers Watson was a one-percentage-point decline over the same period.

Swinburn, who started working at Bass Brewers in his 20s, takes the beer business personally. "When Peter goes to the grocery store with his wife, he typically wanders off after just a few minutes," says Leo Kiely, who heads a joint venture Molson Coors has with SABMiller. "He's gone off to the beer aisle, and he's over there rearranging the shelves, making sure his beer is displayed properly and there are no torn packages."

The brewer is eyeing more deals in the fast-consolidating beer market. Last May it bought Cobra Beer, a British brand popular in curry restaurants. Swinburn intends to keep expanding through acquisitions. "Our balance sheet is strong, so if the right opportunities come around, we can move," the CEO says.

For these new chief executives, survival was the first test. Still, their trials are far from over. As the economy recovers, they have to shift out of crisis mode and focus on long-term strategy and investments. If you come of age in a firestorm, your job has to change when the flames die out. |BW|

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CUSTOMER SERVICE CHAMPS

USAA'S BATTLE PLAN

The provider of financial services for military families uses remote technology and a keen focus on its clients to stay atop our annual customer service ranking

By Jena McGregor

Illustration by Jesse Lefkowitz

When Staff Sergeant Corey Mason wants to deposit a check, he doesn't use an ATM, a teller at a branch, or even a stamped envelope and deposit slip. Rather, the 37-year-old GPS systems specialist takes a picture of the check with his iPhone, uses an app to send it to his bank, and within minutes the money shows up in his account. Although he's now stationed at Fort Knox, Ky., it's the kind of service Mason knows his fellow troops in Iraq, where he served in 2004, surely appreciate. "The mail over there is extremely slow," he says. "They know what it's like."

By "they," Mason means his bank and insurance company, USAA, which counts military members and their families as the bulk of its clients. But he also means the 23% of USAA's top management and new hires that have served in the military. Says Mason: "It's not every day I get addressed 'sergeant' by a customer service agent."

In almost everything it does, the financial-services outfit puts itself in the spit-shined shoes of its often highly mobile customers, many of whom face unique financial challenges. USAA was the first bank to allow iPhone deposits, it routinely texts balances to soldiers in the field, and it heavily discounts customers' car insurance while they are deployed overseas. "They do all this really creative stuff that applies to guys and gals who are in Afghanistan," says Karen Pauli, a research director at consulting firm TowerGroup. "There is nobody on this earth who understands their customer better than USAA."

Although few large companies have such a specialized focus, managers everywhere could learn plenty from USAA about coddling customers. A private company with $68.3 billion in assets, USAA has unrivaled staying power atop *Bloomberg BusinessWeek*'s annual Customer Service Champs ranking (page 42). Since we first produced the list in 2007 with our research partner, J.D. Power & Associates, no other company has come close to achieving USAA's feat: a No. 1 or No. 2 spot for four years running. No fewer than 87% of respondents to J.D. Power's syndicated surveys say they will definitely buy from the company again, far higher than the average, which is just 36%. Its client retention rate? A near-perfect 97.8%.

For USAA, though, maintaining that track record could become a bigger challenge. In November its insurance business scrapped some of its eligibility requirements, more than doubling its potential customer base, from 26 million to 61 million. USAA's property and casualty insurance is now open to anyone who has ever served honorably in the military; in the past, customers had to have served or signed up for USAA between certain dates. And while most of its banking and brokerage

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units have sold to anyone for years, it began advertising those services widely only last year.

While the company has no plans to offer insurance to the general public, expanding beyond its traditional customer could make it harder to provide the same lauded service. For one thing, a broader membership could lead to more consumers who present a greater insurance risk, which may mean service reps will need to be more skeptical about claims, says Brian Sullivan, editor of *Auto Insurance Report*. "If you rarely question the claim, you don't create any conflict," he says.

And while new members may be armed forces veterans and their families, their needs may be different, says Bruce Temkin, who heads up Forrester Research's customer experience practice and has studied USAA. "The real trick for USAA will be how they continue to serve their core military customer while serving this broader set," he says. "It can get really messy if they grow too fast." A USAA spokesperson contends the insurer's pricing will correct for any greater risks that come from expansion.



At a USAA orientation, new employee Sarah Gill tries on a Kevlar vest

For now, USAA is focusing on what it knows best: its armed forces customers and the unique financial issues they face. That focus goes back to its roots, when 25 Army officers got together in 1922 to insure each other's vehicles. By 1972 five out of six military officers belonged to USAA, and in 1996 the company expanded its membership to active-duty enlisted soldiers, too.

So it's little surprise that training for USAA employees is steeped in the military experience. New reps attend sessions where they dine on MREs, or "meals ready to eat," which troops consume in the field. They try on Kevlar vests and flak helmets. And each rep is handed a bona fide deployment letter—with the names changed, of course—to get them thinking about the financial decisions customers face at such an emotional time. Colleen Williams, a Phoenix-based service rep who joined the company in 2008, says the training clued her in to family issues that help her when answering calls. "I speak to women who haven't talked to their husbands in six weeks," she says. "It never really registered to me, the real disconnect" deployed soldiers have from their families.

Training isn't the only thing USAA lavishes on employees. After all, it takes satisfied workers to get satisfied customers. In 2009, even call center agents at USAA saw bonuses nearing 19% of their pay, up from 13.5% the year before. A new $5-an-hour concierge service lets employees outsource errands on the cheap during the workday. And when the company closed two call centers in 2009, it offered every employee a company-paid relocation package to jobs at other locations, even helping staffers burdened with underwater mortgages unload their homes. Of the 1,200 affected workers, 50% accepted move offers, far more than the fewer than 20% USAA expected.

Staffers get time to do their jobs, too. Employees aren't rushed through calls with customers or evaluated on how fast they handle the inquiries. "Member satisfaction trumps every single metric," says Forrester's Temkin. Other call centers "may relax things like average handle time, but they still measure it, and still you get in trouble if you're out of bounds."

Reps are also armed with software that lets them view a history of the online screens a particular customer has viewed on USAA's Web site, letting them know what policies or business lines the customer was perusing—and may be ready to buy.

The mobile lives of its core consumers—troops stationed in distant locales or military families constantly on the move—have made the company an unlikely innovator in the world of personal finance. Because USAA has just one physical bank branch, at its headquarters in San Antonio, deposit-by-iPhone is a logical step. (It also launched an app for Android users on

USAA'S SECRET SAUCE

No other company has rated as consistently high in our customer service rankings. Here's what keeps the San Antonio-based financial-services outfit ahead of the rank and file:

TRAINING
Call center reps spend up to six months in training before manning the phones. The goal: understanding the lives of military customers.

BENEFITS
Better employee benefits can spur better service. So USAA reps get generous health care, bonuses topping 18% of salary, and even relocation.

SYSTEMS
Behind the scenes, USAA has rolled out high-tech software that lets reps view the same online screens its customers see on their PCs at home.

TECHNOLOGY
Mobile is king among USAA's customers. A pioneering service lets banking customers deposit checks by taking pictures using their smartphones.

MATTHEW MAHON

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Jan. 22.) Since August, more than $260 million in deposits have been made using the mobile service, as USAA's customers, whether in Camp Pendleton, Calif., or Iraq, send in checks. Giants like Bank of America are just testing a similar service.

Lieutenant Randall Blakeslee, a plans and operations officer stationed at Fort Sam Houston, Tex., is on two-hour standby to depart for Haiti, where he'll stay at least 90 days to help with relief efforts. That means his mail will be forwarded to him there, and he fully expects to use the mobile deposit service to submit checks from his job at home or when family sends him money. He already used the service to deposit checks when he was based in El Salvador. USAA is "really ahead of the game when it comes to technology," says Blakeslee, 34. "If I'm on the run, I can text a command and within seconds get a message back with my balance."

Blakeslee is referring to another high-tech service USAA rolled out in 2008 that lets its far-flung customers—a sizable number of whom are young, tech-savvy, and living paycheck to paycheck—get text messages about their account balances before, say, making a big purchase. Later in 2010, USAA is planning mobile peer-to-peer payments, which let customers e-mail or text-message money to friends or family for immediate deposit, no matter where they are at the time.

USAA was among the first to let customers initiate an insurance claim using their phones from the scene of an accident. And it soon will expand that app so policyholders can attach photos to the claim and complete the entire process via phone. By 2011 customers will even be able to attach voice recordings to their file, immediately retelling exactly what happened.

Also coming this year: a mobile car-buying service that lets customers standing at a dealership snap an iPhone pic of a vehicle's VIN number and instantly get back insurance quotes, loan terms, and pre-negotiated rates at approved dealerships. "The idea is you can turn that phone around to the salesman," says Bob Otis, USAA's vice-president for auto product management, "and say 'this is the price I'm going to pay.' "

Besides helping policyholders, such technology benefits USAA. As it adds customers, both through advertising banking services for the first time and vastly expanding the pool of vets who can buy its insurance, such self-service tools could mean it won't have to increase the size of its 13,000-strong army of reps at the same rate as its membership. "If you can have the member self-serve on certain parts of the claim, or the entire claim," says Ken Rosen, senior vice-president for claims service, "clearly there's an efficiency gain."

If USAA leans too much on self-service, of course, its vaunted reputation could suffer. Widening its risk pool and taking on more customers could have the same impact. But USAA's executive vice-president for member experience, Wayne Peacock, isn't worried. He says expanding USAA's customer ranks is "gradual and purposeful." And that's something the company has done incrementally since 1996, continually racking up top service scores along the way. | BW |

LOYALL SEWALL

L.L. BEAN FOLLOWS ITS SHOPPERS TO THE WEB

By Michael Arndt

L.L. Bean has never been known as a retail trendsetter. The chinos and rubber-soled boots in its latest lineup could have come from catalogs bulk-mailed decades ago. The company has built a loyal following over the past 98 years with its liberal return policy and folksy sales staff, but it nabbed the No. 1 spot in this year's *Bloomberg BusinessWeek* customer service ranking by adapting to the way its customers shop now.

This year, for the first time, Internet sales will top catalog orders at the $1.5 billion Freeport (Me.) retailer of outdoor gear. But L.L. Bean has done more than install such e-tailing basics as designing a Web site that makes placing orders intuitive and package tracking simple. It switched to a new bank that agreed to split the cost of free return shipping to holders of the L.L. Bean credit card. It also opened the site to customer ratings and reviews of its wares, even if they're negative. Today shoppers can chat with call center agents through instant messaging and e-mail. And by next fall the site will add a "click and call" feature that will prompt a help call within two minutes to any online shopper who wants more information. "Wherever they want to shop, we have to be there," says Terry Sutton, vice-president for customer satisfaction.

The shift from catalog to Web sales has been disruptive internally. Because of declines in phone-in order volume, L.L. Bean in April will close one of its four call centers, 55 miles from its headquarters. The 220 year-round employees affected will be allowed to work from home or another site. Although L.L. Bean management could cut costs by offshoring back-office operations, it has kept them in Maine, where Leon Leonwood Bean founded his mail-order company and his original store. The company offers competitive wages, health-care benefits, discounts, and even a pension.

Sutton says that money is well spent, since happier employees mean better service, which in turn means more repeat business. "The technology has changed the game, but the basics haven't changed," Sutton says. "We treat customers like we'd want to be treated."



"Wherever they want to shop," says Sutton, "we have to be"

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BEHIND THE LIST

We started by delving into J.D. Power's database and then asked readers to weigh in. More than 1,000 responded

For our fourth annual ranking of Customer Service Champs, we began with existing data from J.D. Power & Associates, which each year surveys consumers about customer satisfaction. To assess customer service, we looked at two of their several measures: the perceived quality of a company's staff, and what customers think of its processes, such as return policies or reservation procedures. Therefore, our results may differ from J.D. Power's satisfaction rankings, which also consider quality, presentation, and price.

To qualify for our list, each brand had to receive at least 100 responses. (Some brands may not have had 100 responses to questions about staff but met the sample size criteria overall.)

In order to get a complete score for each brand, we combined the results of all relevant 2009 studies in J.D. Power's database. For instance, J.D. Power conducts separate studies for phone, Internet, and TV service for telecommunications and cable providers, all of which we aggregate into one score. To come up with fair comparisons, we included only brands that appeared on the majority of J.D. Power's studies for that industry. For example, telecom providers had to be included in at least two of the three surveys listed above to rate consideration.

As in past years, we supplemented J.D. Power's database by surveying 5,000 people using the Bloomberg BusinessWeek Market Advisory Board, a panel of readers we contact for feedback on a range of issues. We asked them to nominate three companies they felt were best at customer service and three they felt were the worst. More than 1,000 people responded. We gave the companies with the best ratio of positive to negative nominations to J.D. Power and had it ask consumers about them, applying the same rigor used when surveying companies in its database. As a result, we were able to expand the rankings beyond J.D. Power's data set, which includes only a limited number of retailers. We gave 25 bonus points to brands that did best in our readers' poll.

J.D. Power then ranked all of the brands, weighing the staff score and service efficiency score. To account for differences between industries—upscale hotels, after all, provide a different level of customer service than airlines do—we also gave bonus points to companies that lead their industries and subtracted points for those who rate below third place. As a result, some companies with lesser grades may have high total scores because they rank first in their industries.

For a more complete description of our methodology, go to businessweek.com/go/customer.

—Jena McGregor

CUSTOMER SERVICE CHAMPS

Total scores are based on the first two columns, with bonuses for high scores from readers and industry comparisons

RANK	BRAND/INDUSTRY	QUALITY OF STAFF	EFFICIENCY OF SERVICE	TOTAL SCORE	IDEAS FROM THE BEST
001	**L.L. Bean** Online/Catalog Retail	A+	A+	1055.95	Famous for its lenient returns policy, L.L. Bean gives free shipping on both deliveries and returns to holders of its credit card. It will soon close one of its call centers but keep many workers as home-based agents.
002	**USAA** Insurance	A+	A+	1042.76	An innovation leader in the insurance and financial services industry, USAA lets customers make deposits by snapping photos of checks with a smartphone. Coming soon: peer-to-peer payments via text messages or e-mail.
003	**APPLE** Computers & Electronics	A+	A+	1016.55	Apple's by-appointment "Genius Bars" and its roving in-store checkout clerks are just two ways the company has pioneered new approaches to customer service.
004	**FOUR SEASONS HOTELS & RESORTS** Hotel	A+	A+	1000.90	The weak economy hit the luxury business travel and conference business hard in 2009. To ensure that the front lines remain well-staffed, the hotelier is cross-training back-office workers for other hotel duties.
005	**PUBLIX SUPER MARKETS** Supermarket	A+	A+	992.02	Grocery powerhouse Publix completed installing an inventory system in 2009 that automatically orders replenishments, reducing "out-of-stocks" by 19%. Employees' average stock grant in 2009: $2,326.
006	**NORDSTROM** Department Store	A	A	974.71	Seeking a hard-to-find size in the latest fashion style? Last year the retailer integrated its inventory systems, giving online shoppers access to goods in any Nordstrom store rather than just its online warehouses.

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RANK	BRAND/INDUSTRY	QUALITY OF STAFF	EFFICIENCY OF SERVICE	TOTAL SCORE	IDEAS FROM THE BEST
007	**LEXUS** Automotive	A+	A+	966.44	Despite Lexus' parent, Toyota, being embroiled in a major recall, the luxury brand hasn't yet suffered a dent to its reputation. In June, Lexus began allowing customers to make service appointments online.
008	**RITZ-CARLTON** Hotel	A+	A+	950.74	In a brutal year for luxury travel, the hotelier cut management by 15% and trimmed execs' 401(k) matches. But the number of workers who interact with guests was cut less than 5%, and their benefits spared.
009	**BARNES & NOBLE** Bookseller	B+	A-	944.32	As online competition grows, the bookseller is turning its bricks-and-mortar locations into an advantage, making Wi-Fi free for customers in all of its 700-plus stores in mid-2009.
010	**ACE HARDWARE** Home Improvement	A	A	939.69	The Oak Brook (Ill.)-based hardware co-op last year doubled its mystery shopper program, which secretly has reps shop in local stores to evaluate service, to include 1,252 more of its 4,400 outlets.
011	**AMAZON.COM** Online/Retail	A+	A+	933.55	Amazon's vaunted service helped propel the company to double-digit sales in each quarter of 2009 as other merchants saw sales drop. Last year the online powerhouse started same-day shipping in seven cities.
012	**WEGMANS FOOD MARKETS** Supermarket	A	A+	923.85	The recession notwithstanding, spending on customer service training at Wegmans ran $27 million, up 13% from a year earlier. And that does not include the cost of providing extra staff while workers are in class.
013	**STARBUCKS** Restaurant	A-	A-	923.77	Starbucks' new "lean" process for making drinks has cut out unnecessary steps, improving efficiency and speeding service. But some baristas think the changes also cut into the customer experience.
014	**AMICA MUTUAL INSURANCE** Insurance	A+	A+	920.80	The insurer has a worker turnover rate of just 2%. New technology for Amica's telecom system taps agents in other offices when call volume at a customer's local branch gets overloaded, such as after a hurricane.
015	**CHARLES SCHWAB** Brokerage	A-	B+	918.68	Customer service agents aren't the only Schwab workers prepared to answer clients' calls. A 2008 program to train corporate staffers to man the phones when call volumes rose was expanded last year.
016	**JAGUAR** Carmaker	A+	A+	916.34	Jaguar won top marks for its sales process in J.D. Power's overall satisfaction rankings, which also weigh price, dealership environment, and product quality. Its purchase by Tata Motors hasn't hurt its service rep.
017	**WESTJET** Airline	B+	B+	909.60	Respondents ranked WestJet among the top two airlines for its friendly and reliable service. But the study was completed months before a reservations system change bungled thousands of customer bookings.
018	**AMERICAN EXPRESS** Credit Card	B+	B-	900.46	Training in 2009 stressed relating to customers, not tech skills. And a new hiring strategy for customer service reps targets candidates with experience in the hospitality industry, rather than call center work.
019	**ENTERPRISE RENT-A-CAR** Rental Car	B	B	900.02	While the family-owned rental car giant (National, Alamo) in 2009 had to lay off employees for the first time in its history, the company says fewer than a dozen of them were in positions that face the customer.
020	**BRANCH BANKING & TRUST** Banking	B+	B-	895.91	BB&T is acquiring struggling banks and then running them in a decentralized fashion. A "20-minute rule" requires employees to escalate problems to experts if they can't resolve them in that period.
021	**PANERA BREAD** Restaurant	B+	B+	892.45	The sandwich chain kept hours steady for workers while competitors cut back and is testing a cash bonus program for hourly employees while expanding an incentive program for long-term managers.
022	**TRUE VALUE** Home Improvement	A-	A	879.02	A customer feedback program is giving True Value's 5,000-plus co-op hardware stores details on what customers think of individual units. Corporate is helping local stores mine that data.
023	**DELL** Computers & Electronics	B+	A-	872.64	The PC maker actively uses social media like Twitter to help handle service issues. Although its score improved this year, Dell also settled a $3.85 million lawsuit in 2009 over financing, service, and warranties.
024	**SOUTHWEST AIRLINES** Airline	B	B+	871.84	It's the only U.S. major that doesn't charge fliers to check two bags. While that costs it fee revenue, management credits the policy for helping to boost customer loads and revenues per seat by7% in December.
025	**FAIRMONT HOTELS & RESORTS** Hotel	A+	A+	871.65	A new program provides a chauffeured car service to hotel guests needing local transportation. Employees get a discount for friends and family who stay in Fairmont hotels, plus a payment when they do.

Data: J.D. Power & Associates, Companies, *Bloomberg BusinessWeek*

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THE PENSION FUND THAT'S BEATING PRIVATE EQUITY

By Jason Kelly

Photography by K.C. Armstrong

How a massive pension plan in Canada is end-running private equity—and racking up better returns

Even as the economy slid into the recession, Jim Leech was making private equity deals. In 2008 he picked up a Chilean utility. Last year he bought a $211 million stake in U.K.'s Bristol International Airport. Now Leech is making a hostile bid for Australian toll-road operator Transurban Group, offering $6.2 billion. If consummated, the deal will be the largest buyout since the credit markets collapsed nearly three years ago.

There are a couple of reasons Leech never had to step away from the negotiating table. He doesn't have to rely on borrowed money, and he doesn't have to court investors. He has plenty—almost 300,000, in fact. They are the teachers of the Canadian province of Ontario, and as CEO of their $83 billion pension fund, Leech is charged with protecting their retirements. That sets him apart from rival dealmakers at Kohlberg Kravis & Roberts, Blackstone, and Carlyle Group.

Most public pension funds, such as California Public Employees' Retirement System (CalPERS), have outside money managers pick their investments. The Ontario Teachers' Pension Plan does much of its private equity investing directly. It has bought or picked up stakes in almost 300 companies over the



Leech holds assets for the long term, keeping the fund competitive with private equity

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Clarke is helping Ontario Teachers' back a hotel-condominium-mall

INSIDE ONTARIO

The pension fund has bought or picked up stakes in 300 companies since 1990

GNC
The biggest retailer of health and wellness products, it has had18 straight quarters of same-store sales growth.

SIMMONS BEDDING
Teachers', along with Ares Management, bought the mattress maker out of bankruptcy this year. The pension fund bought Serta Mattress in 2005.

MAPLE LEAF SPORTS & ENTERTAINMENT
The unit is teaming up with Ontario Teachers' real estate group on a $500 million development.

AQUILEX HOLDINGS
The company provides maintenance and repair services to energy-related businesses including oil refineries.

Data: Ontario Teachers' Pension Plan

past two decades. Simmons Bedding, the General Nutrition Centers vitamin chain, and the Toronto Maple Leafs hockey team all belong in part to the educators of Ontario. The teachers paid cash for Aquilex Holdings, an industrial cleaning company, just weeks after the fall of Lehman Brothers in late 2008. "Even when other private equity firms were on the sidelines, we were there," says Leech.

Leech's strategy of keeping leverage in check and holding assets for the long haul has kept the fund competitive with the big boys of private equity. Since its inception in 1990, Ontario Teachers' private equity arm has earned 19.6% a year, in line with top firms. In 2008 the private equity group lost 13%, vs. nearly twice that for the average buyout fund. (Some 40% of its private equity assets are managed by outside investment firms, including many of the same ones it teams up with to make deals.) Ontario Teachers', which also holds stocks, bonds, real estate, and other alternative assets, made a bad bet on fixed income in 2008 and was down 18%. That made it the fund's worst year, but it still topped CalPERS, which lost 26%.

Ontario Teachers' success may eventually change the shape of private equity investing. Other pension funds are beginning to invest on their own. Ontario Teachers' partner on the Trans-urban deal is the Canada Pension Plan Investment Board. "We operate more like Goldman Sachs Asset Management" than a pension fund, says Mark Wiseman, who left Ontario Teachers' to help Canada Pension Plan develop a private equity strategy. Dutch civil service pension fund ABP owns a portfolio of companies, including Imagem Music Group, the music publisher. Australian pension funds are buying up bridges, toll roads, and other infrastructure.

"A CLEANER STRUCTURE"

Direct investment may also become more attractive to pension funds in the U.S., where state and federal authorities are investigating relationships between big pension funds and their outside money managers. Private investment firms paid at least $125 million to middlemen to help win lucrative contracts from CalPERS, according to a report by the pension fund. "The motivations to go direct are higher than they've ever been," says Colin Blaydon, director of the Center for Private Equity & Entrepreneurship at Dartmouth College's Tuck School of Business. "It's a much cleaner structure with less potential for conflicts." Says CalPERS spokesman Brad Pacheco: "CalPERS has acted quickly, adopting a strict

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CADILLAC FAIRVIEW
Teachers' real estate subsidiary manages properties including the Toronto Eaton Centre and Calgary's Chinook Centre.

policy to require disclosure about placement fees and sponsoring a bill that would end contingency fee arrangements."

Ontario Teachers' began dabbling in private equity in 1990, just one year after KKR's landmark leveraged buyout of RJR Nabisco. Back then, the pension fund was invested entirely in low-yielding Canadian bonds and was having a hard time making high enough returns.

Claude Lamoureux, then the fund's CEO, decided to try operating more like a Wall Street money manager. The pension fund's first buyout, in 1991, was a bust. It paid $15.75 million for White Rose Crafts & Nursery Sales and planned to expand the business. Within a year the company filed for bankruptcy, and Ontario Teachers' lost its investment.

The failed acquisition is immortalized at the pension fund's headquarters on the northern outskirts of Toronto. Four vertical four-foot-high metal sheets listing Ontario Teachers' deals hang on what is called the Wall of Fame and Shame in a conference room. "We could've said, 'Well, we drilled a dry hole' " and ditched the do-it-yourself private equity plan, says Leech, the 62-year-old former banking and energy executive who joined the pension fund in 2001. "The amazing part is that there is a wall at all after that experience."

Today a team of 50 in-house money managers, whose paychecks compare to those of Wall Streeters, considers potential investments. The fund made a push into emerging markets in 2005, launching with a crash course for managers dubbed Project Atlantis. The managers took 10-day trips to Turkey, Brazil, and South Africa, meeting with government officials, financiers, and business owners. At a cocktail party in 2006 they chatted with Eike Batista, the Brazilian billionaire. One year later Ontario Teachers' bought a 15% stake in one of his mining companies, LLX Logística.

In 2007, Leech and his successor as head of private equity, Erol Uzumeri, reorganized the group by industry specialties. The structure helps Ontario Teachers' assess potential deals a long time before companies become available. Three years ago the financial-services team began to study the insurance business. It met with top executives and dissected the operations of large insurers, including American International Group. So when AIG's Canadian mortgage business became available after the U.S. government bailout in late 2008, the team knew that it was interested. After the pension fund spent a year working on the acquisition, the AIG acquisition was announced on Jan. 5.

Like many private equity owners, Ontario Teachers' operates like a mini conglomerate. The acquisition of Simmons Bedding for $760 million in January, made along with Ares Management, fit nicely with another Ontario Teachers' holding, National Bedding, maker of Serta mattresses. When Leech was considering buying GNC in 2007, he called executives at the real estate developer Cadillac Fairview, which the fund had bought in 1999. Leech says he asked whether Cadillac Fairview wanted GNC in its malls and whether the vitamin retailer paid its bills on time. "They have a good outlook on how to run the business, and they're not engulfed in the day-to-day," says GNC Chief Executive Joseph Fortunato. "They've been a pretty ideal owner."

Cadillac Fairview has paired up with the pension fund's Maple Leaf Sports & Entertainment unit to build a multi-use development that includes the Maple Leafs' arena. Maple Leaf Square, a $500 million, 1.8 million-square-foot project, will feature a boutique hotel, condominiums, and a retail area. Ian Clarke, Maple Leaf Sports' executive vice-president in charge of business development, hopes to meld the excitement of game day—a giant high-definition screen will show games live in the plaza outside the arena—with shopping.

SORRY, WRONG NUMBERS

As with private equity firms, Ontario Teachers' has made moves it regrets. In 2007 it put together an investor group, including Merrill Lynch's buyout unit, to make a $43 billion bid for BCE, Canada's largest telephone company. The deal immediately began to unravel, and Ontario Teachers' and its partners ultimately walked away, citing an auditor's report that BCE would end up insolvent because of the debt it would have had to take on. BCE and the would-be acquirers are now fighting over a $1.1 billion breakup fee. "It was a product of a euphoric time," says Leech.

That Ontario Teachers' wasn't destroyed by the froth leading up to the financial collapse goes back to the biggest difference between Ontario Teachers' and traditional private equity firms: their investors. The managers are constantly reminded of whose money they are looking after. Retired teachers often stop by the headquarters to pick up their benefit checks; executives talk about extended family members who are pensioners. With retirees soon to equal active fund participants, dealmaking and returns will become more critical. "We have to look at an investment strategy that responds to the situation," says Leech. "It's just the math." | BW |

"THEY HAVE A GOOD OUTLOOK ON HOW TO RUN THE BUSINESS, AND THEY'RE NOT ENGULFED IN THE DAY-TO-DAY"

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WHAT'S NEXT

Korean Tech Is Losing Its Cool

How the onetime digital trendsetter became a laggard in an era of smartphones—and amazing apps

By Moon Ihlwan

SEOUL

For more than a year, Bae Jae Hyun wondered why her friends were so excited about the iPhone. She was happy with her Korean-made handset and puzzled by the desire for a phone that wasn't even available in the country. But when the iPhone arrived in Korea in November, it didn't take long for Bae to change her mind and buy one. "I now understand why they were so obsessed with it," says the 22-year-old student.

In December, Koreans bought some 200,000 iPhones—the best month ever in Korea for any handset model. In a country where domestic giants Samsung and LG together control 80% of the cell-phone market, that's quite a coup for Apple. "The iPhone is so much better than any Korean phone I've ever seen," says Kim Ho Heok, a schoolmate of Bae.

The iPhone's popularity is a sign that Korea may be losing its edge in the international market, despite its reputation as the epicenter of digital cool. The country still rules in hardware, but it is stumbling in software. Samsung and LG, the No. 2 and No. 3 global handset makers, together manufactured nearly a third of the world's mobile phones last year, but their share of the smartphone market was just 4%. That's important because smartphones offer greater profits than traditional handsets, and they are increasingly popular with customers. The Koreans have rolled out models featuring touchscreens, high-resolution cameras, and TV. But they're often clunkier to use than rivals from Apple and Research in Motion, maker of the BlackBerry.

1.8%

Korea's global market share in software, vs. 50% in memory chips and LCD panels and 35% for flat TVs

Data: Ministry of Knowledge Economy (Korea)

Korea's software shortcomings are of growing concern to the country's political and business leadership. On Feb. 4, President Lee Myung Bak convened a special cabinet meeting to address the issue. Ministers were told the country accounts for only 1.8% of the world market for software of all kinds, even though it dominates sales of memory chips, liquid crystal displays, and flat-screen TVs. While Samsung sold 227 million handsets last year—10 times as many as Apple—its earnings were lower because its profit margins are much slimmer. "The government had been preparing to shift our focus to software from hardware for about a year, but the iPhone sensation provided a wake-up call," says Lee Sang Jin, who oversees the software division at the Ministry of Knowledge Economy, known until two years ago as the Ministry of Commerce, Industry & Energy.

"THE POLICY BACKFIRED"

Seoul, which has long played a big role in guiding important industries, has launched a state-funded program to nurture software startups. The Ministry of Knowledge Economy is budgeting some $880 million to back software companies over the next three years. It aims to double the number of Korean software engineers to 300,000 in 2013 from 2008 and triple software exports to $15 billion.

A previous government attempt to boost the software industry was something of a dud. Seoul in 2005 required handset makers and content providers offering products or services in the country to use a Korean technology for Internet access instead of the programs used in most other countries. The rule was rescinded last year, but it clearly slowed the foreigners: The iPhone hit Korea more than two years after its U.S. debut. The downside is that Korean software writers were left with programs that worked only in their home market. As a result, they received scant



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Recent iPhone convert Bae: The apps make the difference

JAE-HYUN KIM

exposure to the rigors of the global marketplace. "The policy backfired for Korea by stopping competition for innovation," says Chung Tai Myoung, an engineering professor at Sungkyunkwan University.

SOFTWARE SUCCESSES

Samsung and LG say they intend to expand their smartphone lineups and offer more applications to run on them. "We have tremendously strengthened our software, which has been our weak spot," says J.K. Shin, president of Samsung's handset business. On Feb. 14, Samsung unveiled a software platform called *bada* ("sea" in Korean) to let outside developers create programs for its devices. And LG last December set up a unit with more than 800 programmers focused only on smartphones. This year the company expects to introduce about a dozen models using Google's Android operating system. "We are trying to offer more than the iPhone," says Skott Ahn, LG's mobile phone chief.

Despite the government's software worries, Korea has had some notable successes. Lineage, an online fantasy game made by Seoul-based NCsoft, has a cult-like following across Asia. Social networking service Cyworld, which was launched earlier than Facebook, is dominant in Korea. After eight years of offering Korean-language search, Google has just 2% of the market, compared with 64% held by Naver, headquartered in a Seoul suburb. And Qualcomm on Feb. 1 announced plans for a research center in Seoul to work on multimedia applications. "We see great potential in Korea," Qualcomm Chairman Paul E. Jacobs said at the time.

Yet when it comes to smartphones—perhaps the most important new sector in the technology business—young Koreans don't expect much from homegrown alternatives to Apple or BlackBerry. "I don't think I'll want a Korean phone in the next few years," says Yoon Ju Hwan, a 30-year-old fund manager who bought an iPhone in December. "We simply don't have the capabilities to create the kinds of things Apple does." |BW|

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Overzealous Regulators?

Some software makers in South Korea are complaining that a government rule is killing off their business, reports the newspaper *Hankyoreh*. A Seoul mandate that security for online transactions use a technology that works only with the Internet Explorer browser presents an obstacle for local companies attempting to develop applications for the iPhone and other gadgets.

To read the article, go to **http://bx.businessweek.com/mobile-applications/reference/**

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The Man with the Toughest Job at GM

James Campbell was plucked from obscurity to run Chevrolet. Why? He knows his customers

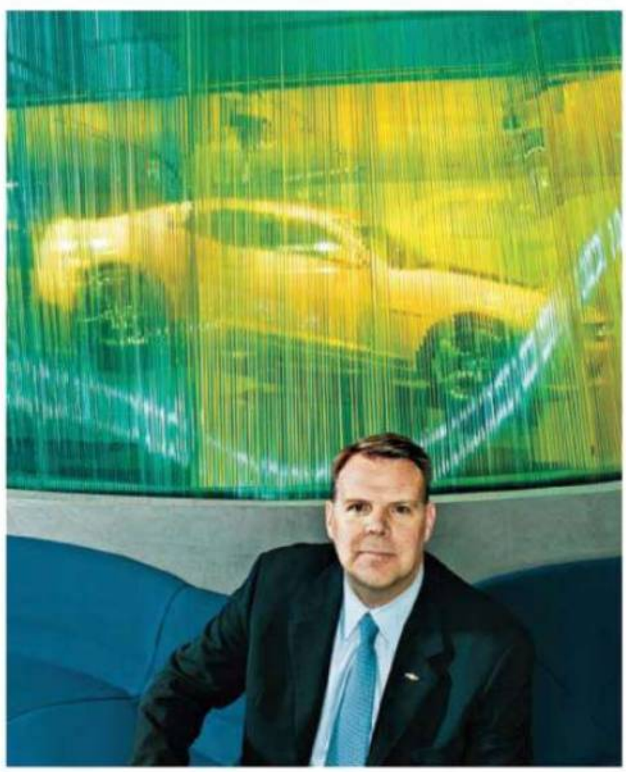
By David Welch

Chevrolet has a new chief, and James Campbell is as surprised as anyone that he's it. Campbell, who spent some 22 years helping dealers market cars, is one of several young executives promoted by CEO Edward E. Whitacre Jr. General Motors' chief expects Campbell to restore luster to a brand that now accounts for about 70% of GM's U.S. sales and has been losing share for years. "There's a lot of work to be done," acknowledges Campbell, who was appointed in December.

Campbell, 45, may seem a strange choice to run GM's most important brand. In a bombastic industry, his mien is more credit-union VP than flashy pitchman. A few years ago Campbell turned down a potentially career-making opportunity to run Chevy's marketing operations in China; after that many of his assignments were decidedly unglamorous (such as selling cars to rental companies). But Campbell's bosses say that his years on dealer lots gave him insights into the middle- and working-class people who buy Camaros, Malibus, and Tahoes. Campbell, who grew up in Michigan, notes that he comes from a Chevy-driving family. "He is Chevrolet," says GM's North American chief, Mark L. Reuss.

Campbell comes from a Chevy family—his first car was a used 1969 Chevelle

Campbell inherits a brand showing nascent signs of life, partly as a result of GM's post-bankruptcy marketing blitz and Toyota's meltdown. *Consumer Reports'* annual brand perception survey, released in January, shows that Chevy has zoomed from ninth to fourth place, finishing ahead of BMW and Mercedes. Edmunds.com reports that more visitors to its site have been shopping for Chevys of late. Such trends often predict a sales surge; they did for Ford Motor last year.



For Campbell, the challenge will be getting Americans excited about the new small cars joining Chevy's lineup this year and next. His strategy is simple: buy lots of Chevy ads on sites where people go to price Toyotas and Hondas. "If they are shopping a Camry or Accord," he says, "we serve up information on the Malibu."

GM is phasing out Pontiac and Saturn, and Campbell wants to keep the 6.5 million customers who bought those brands over the past decade out of rival carmakers' showrooms. So he is trying to make it easier for them to stick with GM. Campbell already has dealers filling customers' in-boxes and mailboxes with deals on service and repairs. Next, he plans to offer potential buyers discounts on new Chevys.

In recent years, as Chevy kept raising the discounts, Toyota used philanthropy and guerrilla marketing to make it seem as American as Motown. Campbell wants to remind people that Chevrolet was there first. He's putting Chevy cars on display at Little League baseball games and letting people test-drive cars at second-tier auto shows around the country.

Campbell will have to keep discounting cars. But dealers say he is more strategic about discounting than GM has been in the past. Duane Paddock, who owns Paddock Chevrolet in Kenmore, N.Y., says he and other dealers told Campbell last year they needed to move their used cars before they could persuade people to pay more for new ones. Campbell got GM to offer cut-rate loans, but only on used models that were piling up. "He calls and wants to know what consumers want," Paddock says. "He actually uses our suggestions."

A man who never dreamed he'd be running Chevy has GM's hardest and most urgent job. With Whitacre determined to free GM from government shackles, Campbell may not have much time to prove his mettle. "As goes Chevy," he says, "so goes GM." |BW|

ROY RITCHIE/WONDERFUL MACHINE

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Testing Aquamarine's wave power system off the Scottish coast

ECONOMICS & POLICY

Now, an Alternative to Alternative Energy

Big money is starting to flow into biomass, geothermal, and marine wave power projects

By Mark Scott
LONDON

When oil prices crashed and credit markets froze in 2008, private investment in alternative energy withered. "The last 18 months have been extremely difficult" as risk-averse investors shied away from green tech, says Martin McAdam, chief executive of Aquamarine Power, an Edinburgh-based company developing power plants that tap energy from waves. Wind and solar projects were kept alive, however, thanks to some \$3 billion in government subsidies in the U.S. alone, and many more billions overseas. Nearly 8,000 megawatts of new wind capacity was installed in the U.S. in 2009, according to Bloomberg New Energy Finance (NEF).

Now, backers of other green projects—largely shut out to date—are seeing some government lucre as well. "Solar and wind got all the attention, but new funding is putting geothermal and other technologies front and center," says Karl Gawell, executive director of the Geothermal Energy Assn. in Washington. So far, at least \$500 million in government backing has gone to such projects worldwide.

TURNING TIDE

It's a big boost for what you might call alternative alternative energy. Geothermal power (tapping into heat deep inside the earth) will increase by more than 40% by 2013, according to NEF. The firm expects power from biomass—organic material such as wood chips, farm waste, and grass clippings that is burned to produce electricity—to jump by nearly a third over the same period. And market researcher Frost & Sullivan figures output from systems that harness ocean waves will go from almost nothing to more than 3,000 megawatts, equivalent to four coal power plants, by 2020. "Governments want to fund as many technologies as possible to meet their [green energy] commitments," says Alex Klein, research director at Emerging Energy Research in Cambridge, Mass.

While they're generally more expensive, these technologies offer at least one advantage over wind farms and solar arrays: They don't depend on favorable weather, a problem for wind and solar on calm or cloudy days. That helps developers negotiate better financing terms because they can guarantee a steady supply of electricity—for which utilities are willing to pay a premium. Düsseldorf-based power company E.ON and Britain's Scottish and Southern like the idea so much they're spending more than \$500 million for their own biomass plants, which will benefit from government price supports.

These technologies aren't without peril. Newer geothermal plants in California and Switzerland that drill deeper than traditional setups are believed to have caused small earthquakes, leading to questions about the technology's safety and viability. Marine energy has yet to be proven at scale. And investment in biomass may stall if prices for wood chips and plant waste climb as demand surges.

Despite those concerns, increased state backing has started to unlock private capital. Some European governments guarantee above-market prices for energy from such installations, allowing investors to lock in profits. Aquamarine, for instance, has secured \$10.2 million in British government grants and promises of a minimum price for power, which has helped attract new backers.

Boston private equity firm Denham Capital Management knows the value of such support. Denham holds a controlling stake in Hamburg-based Novus Energy, which operates two biomass plants in Germany. Scott Mackin, a partner at Denham, says German price guarantees for the plants' output mean the company can count on stable returns. "The subsidies," he says, "were the main reason we invested." |BW|

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In Britain: One Urban goal for Europe is to have 200 stores in 10 years

GRAHAM TROTT

STRATEGY & COMPETITION

Urban Outfitters' Grow-Slow Strategy

By studying local fashions first, it hopes to succeed in Europe where others have stumbled

By Michael Arndt

European retailers from Ikea to Zara have found plenty of shoppers by coming to America, but U.S. chains have had a harder time going in the other direction. Gap's sales have been sliding in Europe since 2005, while Wal-Mart Stores simply gave up in Germany, the Continent's biggest market, in 2006.

Now Philadelphia-based Urban Outfitters is intensifying its push across the Atlantic and hopes its designed-in-Europe strategy will beat the odds.The retailer will open its second Anthropologie women's apparel store in London in March, followed by five more Urban Outfitters clothing stores across Europe by yearend. The company, which already has 18 Urban Outfitters in Europe, then intends to pick up the pace to get to 100 European stores for each chain within the next decade, says John E. Kyees, chief investor relations officer. If that goal seems modest—Gap already has 180 European sites—that's the point. "We're not one of these companies that think rapid growth is really great," Kyees says.

Urban Outfitters began its European venture differently, too. U.S.-based chains such as Abercrombie & Fitch stock their European stores with the same merchandise they sell at home.

HOW TO PLAY IT 062

But before opening its first store in Europe in 1998, Urban Outfitters set up a separate design and merchandising unit in London so it could tailor its goods to European tastes. The duplicate operation increased overhead and delayed profitability in Europe, but the mix of American and European styles helps Urban Outfitters stand out. "It's hard to find a company that offers something similar," says Kimberly Picciola, a retail analyst with Morningstar.

Urban Outfitters could use the euro-growth. After increasing worldwide revenue an average of 22% annually from fiscal 2003 to 2009, the company said sales expanded just 6% in the year ended Jan. 31, to $1.94 billion. While per-store revenue rose 10% at Anthropologie and 18% at the newer Free People women's clothing subsidiary, sales at the namesake chain slipped 1%. Urban Outfitters' shares, which closed at 31.20 on Feb. 16, nonetheless have outperformed the Standard & Poor's 500-stock index over the past two years.

Europe is known as a crowded and high-cost market for retailing, and competition from other U.S. clothing chains is growing. American Apparel has 51 stores across 11 countries, and Abercrombie has 12 Hollister stores in shopping malls in the United Kingdom and Germany, with plans to triple that number this year. On a per-unit basis, though, Urban's European stores have the same healthy results as those in the U.S., Kyees says. Europe now accounts for nearly 10% of total revenue.

The company's wanderlust doesn't stop on the Continent. Senior managers recently scouted locations in China, Japan, and South Korea for what eventually could be 100 stores in Asia. The first, Kyees says, might open in 2013, giving the company plenty of time to study local tastes. BW

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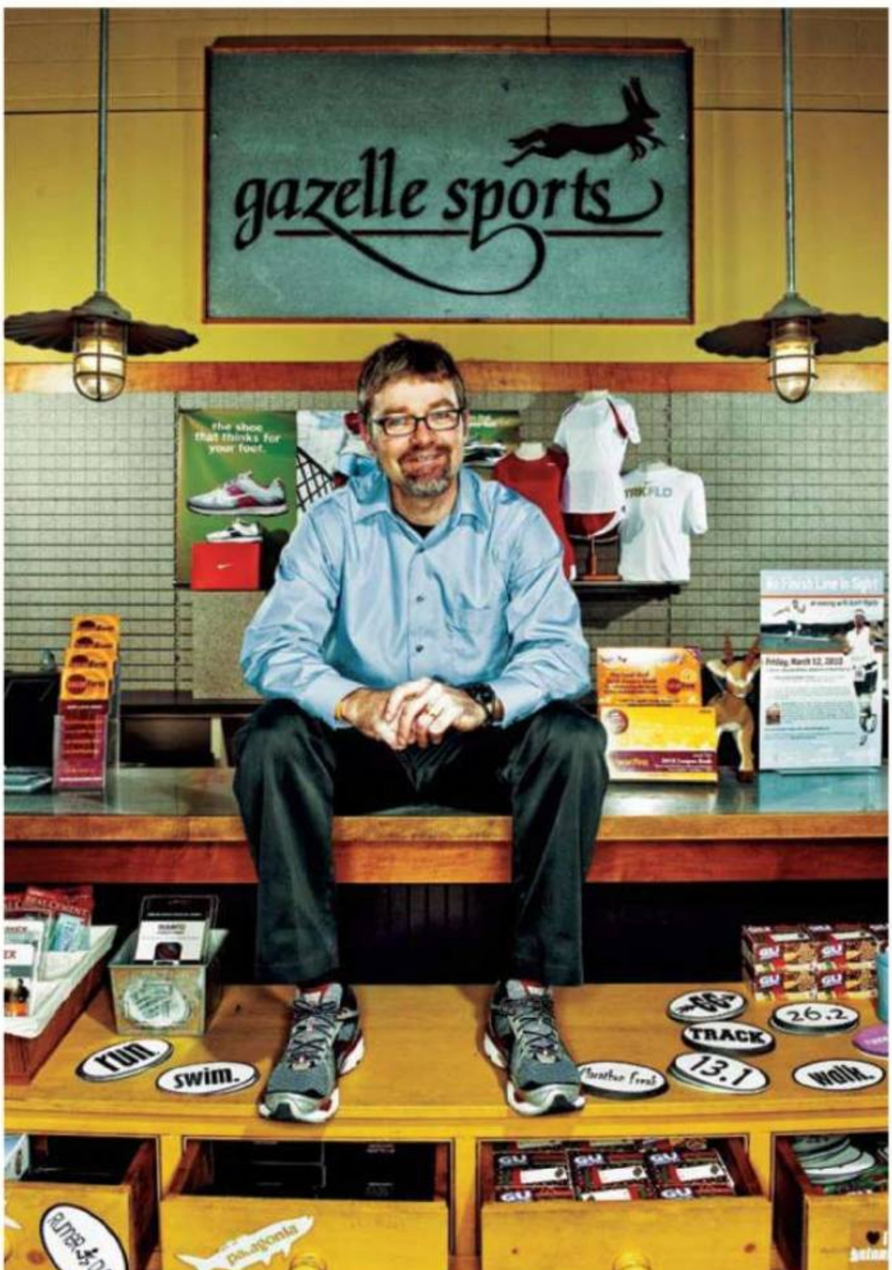
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SMALL BUSINESS

Why More Are Buying Into 'Buy Local'

A growing number of cities and regions are lauding the benefits of backing homegrown businesses



ROY RITCHIE/WONDERFUL MACHINE

Lampen-Crowell has seen steadier growth since joining a "buy local" group

By Kimberly Weisul

By now, residents of Seattle's Capitol Hill neighborhood have figured out that their trendy new coffee shop, 15th Ave. Coffee & Tea, is actually owned by Starbucks. With fresh flowers, beans ground to order, and a "help yourself" policy regarding used coffee grounds—for composting, of course—the store could pass for a locally owned café.

Starbucks' "unbranding" initiative is just one sign of the growing influence of the "buy local" movement—a longtime New Urbanist dream that has finally started to become a reality in the past two years. Shoppers such as Lauren and Skip Schumann of Charleston, S.C., have taken to heart the movement's pleas to buy within their town, or at least within their state, before searching elsewhere. The couple bought their wedding rings at Croghan's Jewel Box, a fixture on Charleston's King Street. They won't eat at chain restaurants. Lauren is shopping for a home security system, and only locally owned companies need apply. Charleston is still a small town, she says: "If one store closes, everybody knows it. It's kind of a doomsday feel."

Michael Shuman (no relation), director of research and economic development for the nonprofit Business Alliance for Local Living Economies, says boarded-up downtowns, the recession, and news about tainted goods from China have all made an impact. Two other factors have also been decisive: "If there had been no oil crisis and no financial crisis," he says, "we'd be whistling in the wind."

SAVING JOBS

Advocates say that locally owned stores spend proportionately more on payroll than chains and that buying local will save jobs. Plus, for every $100 spent at a locally owned store, $45 remains in the local economy, compared with about $13 per $100 spent at a big box, according to research by the nonprofit Institute for Local Self-Reliance and Austin (Tex.) consulting firm Civic Economics. That's because independents tend to do their purchasing locally, while chains

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COMCAST BUSINESS CLASS

LESSONS LEARNED

Lesson 1: Marketing for Growth

Big results are still possible from small marketing budgets, say savvy small business owners. The key is shifting to trackable, results-oriented marketing tools available online.

Expert positioning

Pegasus Associates Lighting (www.pegasusassociates.com) in Beaver Falls, PA "historically hasn't spent much on marketing," says its vice president, Chris Johnson. The commercial and residential lighting retailer, which began as a lighting representation firm, moved its business online in 1999 to broaden its reach. Its net income grew more than 8,000% last year thanks to its marketing shift.

That success is due in part to its expert positioning within the lighting industry. Step one of that strategy was designing its website as "a learning experience," rather than simply a product database. The content available there has grown from around 20 pages to more than 1,000, and pushed it onto the first page of most Google lighting searches.



Social media

Another marketing tool that works for Pegasus Lighting is social media - namely Facebook and Twitter. Creating a Facebook fan page, buying targeted Facebook ads and tweeting regularly have more than doubled the company's fans, at a cost of only a few hundred dollars a month. "It's a cost-effective way to get our name out," says Johnson.

Mark Skorlich, CEO of CaliforniaBlooms.com in Burlingame, CA goes so far as to say about social media, "You have to be there." His company focuses mainly on Twitter, with strong results. Its October breast cancer awareness promotion via Twitter garnered attention from The Ellen DeGeneres Show after Ellen was voted most deserving of a floral bouquet from the company, and received a tweet back from the comedienne containing a photo of the gorgeous blooms for all of her 4,093,000 followers to see.

"Step one of that strategy was designing its website as a 'learning experience' rather than simply a product database."

Public relations

What's even more cost-effective than social media, however, is public relations, says Skorlich, who uses free services such as HelpaReporter.com to learn what stories reporters are working on. Responding to their requests for sources has netted CaliforniaBlooms thousands of dollars in free print and broadcast publicity.

Mobile apps

Since he hasn't had to pay much for media coverage, Skorlich's marketing budget has been invested in developing a mobile application for the iPhone, which he believes is the next big marketing tool. His mobile app will enable cell phone users to instantly send flowers from CaliforniaBlooms. Skorlich believes his company is the first of 30,000-40,000 merchants on Yahoo! Shopping to venture into mobile apps. Within the next couple of years, he expects as much as 25% of CaliforniaBloom's business will originate via the company's mobile app.

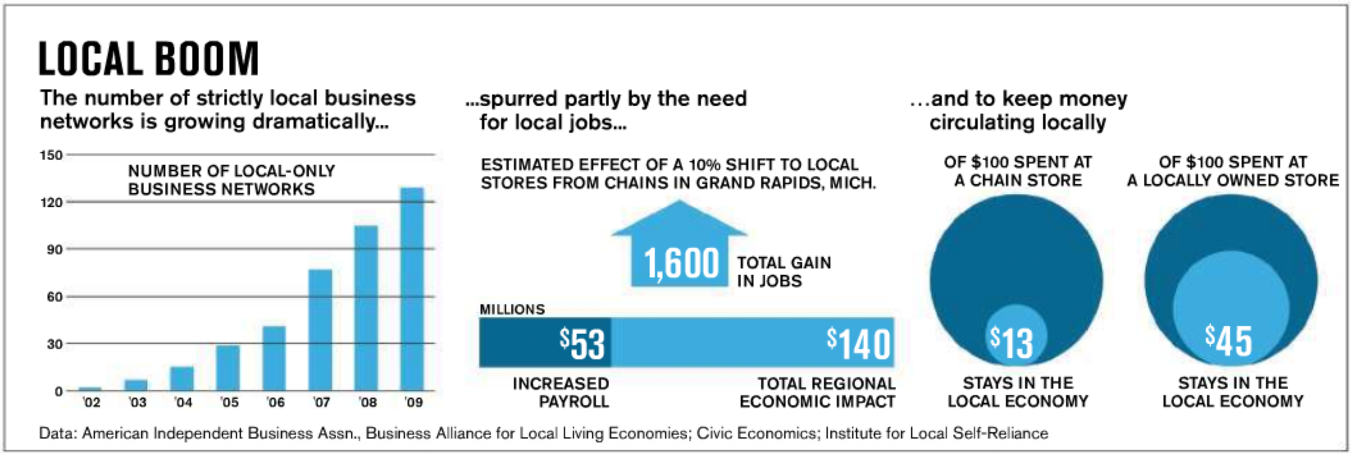
While turning its attention to online marketing to attract new customers, Pegasus Lighting has also "pulled back on offline marketing because it's hard to track," says Johnson. Being able to track results enables the company to spend more on what works and less on what doesn't, which is fueling both growth and profitability.

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usually centralize it from a head office.

About 130 cities or regions now host "buy local" groups, representing about 30,000 businesses, up from 41 in 2006. The membership of South Carolina's Lowcountry Local First has doubled in the past year, to 325 businesses. Local First in Grand Rapids, Mich., has almost 600 members, up from 150 three years ago. Even as chain stores promote themselves as "local," a wave of new national groups is backing independents. The 10% Shift asks shoppers to shift 10% of their purchases to local stores; Move Your Money wants you to move your bank account from a national outfit to a local bank or credit union. The rationale: Smaller banks usually are more supportive of small businesses, don't pay huge bonuses, and didn't get taxpayer-funded bailouts.

In March 2009, when retailing blogger Cinda Baxter asked readers to choose three local businesses and to spend $50 at each, she received more than 350 e-mails that first weekend. Her 3/50 Project now has about 42,300 Facebook fans, and more than 265,000 people have visited its site.

Advocates admit it's tough to quantify the impact of local purchases. But in 2007 booksellers in San Francisco asked Civic Economics to calculate what would happen if Bay Area consumers shifted 10% of their spending from chains. The forecast: $192 million in increased economic activity for the region and almost 1,300 new jobs. "If any single business promised that, the governor would be downtown handing out checks," says Dan Houston, co-founder of Civic Economics. That study, plus a similarly positive one in 2008 in Grand Rapids, helped reframe the buy-local argument. "It's no longer absolutist," says Houston. "It's not that you're wrong to go to Target. We're saying: 'Here's the value you could create in your community if you made some changes.' "

CITY FUNDING

Not everyone is convinced. "Productivity creates wealth," says Russ Roberts, an economics professor at George Mason University. "It doesn't matter if you keep the money in your [local] economy." In fact, he says, while it's simple to count the jobs gained by promoting local purchases, it's impossible to measure accurately the jobs lost because of a change in buying habits.

People tired of boarded-up downtowns reject that view. Tacoma, Wash., Santa Fe, N.M., and Bozeman, Mont., have all provided five-figure grants to help start independent business associations. Utah Local First, with 2,500 members, gets funding from both Salt Lake City and the county. Grand Rapids Local First helped persuade its town to give a 1% bid preference to local businesses. And on Feb. 8, New Mexico's House of Representatives voted unanimously to allow the state to move up to $5 billion of its money into local banks or credit unions.

In Grand Rapids, Chris Lampen-Crowell's Gazelle Sports sells sporting gear and shoes at full retail price. That's a tough gig, with Foot Locker, Finish Line, Dix Sports, and MC Sports—never mind the Internet—all within easy reach of his shop. Growth "has been steadier since we joined" Local First, he says, and his 2009 sales rose 7%, thanks in part to contacts he's made through the group.

Art Johnson, chief executive of United Bank of Michigan, with 11 branches within 30 miles of Grand Rapids, says customers like the fact that he's not a Wall Streeter. "People ask if we are really local," he says. "We have to prove it to them." His response: Ask other bankers what their stock symbol is. "If they have an answer, they're not locally owned." |BW|

Business Exchange

Read, save, and add content on BW's Web 2.0 topic network

Investing in Main Street

Investors who want to buy shares in local businesses are often thwarted by securities rules enacted after the Great Depression. John Katovich, ex-general counsel of the Pacific Stock Exchange, is trying to change that by developing a system for issuing shares—and an exchange to trade them—that will be affordable for small companies.

To read Katovich's blog, go to **http://bx.businessweek.com/social-entrepreneurship/reference/**

CHART BY STANFORD KAY

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PERSONAL BUSINESS



Building a bridge in Henan: China is spending billions on infrastructure

DONALD CHAN/REUTERS

MONEY REPORT

A WELL-BUILT FUND RIVAL

The T. Rowe Price Global Infrastructure Fund, launched on Feb. 11, is likely to prove a tough rival to the more established funds in its category. Annual costs are estimated at 1.31% of assets—about a fifth less than the average charged by competing mutual funds. Plus, retail infrastructure offerings from Morgan Stanley and Cohen & Steers charge front- or back-end loads, while T. Rowe funds are no-load. The funds invest in a variety of companies that build roads, utilities, and other projects.

T. Rowe portfolio specialist Nick Beecroft says the fund currently has about a third of its holdings in North America and the rest overseas. Right now, infrastructure companies in emerging markets look very favorable. "We have significantly more emerging-markets exposure than is commonly found in a global fund," says Beecroft. India alone, he says, is likely to spend around $750 billion on infrastructure in the next eight years. Likewise, China will continue to pour money into infrastructure development. Investors eager to tap directly into these markets can also consider these exchange-traded funds: iShares S&P Emerging Markets Infrastructure and PowerShares Emerging Markets Infrastructure, up 22% and 30%, respectively, over the past year. *-T.K.*

CURRENCIES

NEW YEAR RALLY?

The Chinese New Year, which kicked off on Feb. 14, could very well augur a U.S. dollar rally against the Japanese yen, according to research from BNP Paribas. In 15 of the past 20 years, the dollar hit a bottom against the yen within a few days of Chinese New Year. According to the Feb. 10 report, "the reasons behind this seasonal rally remain difficult to underpin."

One explanation could be the fiscal yearend for Japanese companies on Mar. 31. In anticipation, Japanese investors tend to cash out of non-Japanese holdings. But "once these repatriation flows are completed, the U.S. dollar tends to reverse course." Last year the dollar gained 11% on the yen from the start of Chinese New Year on Jan. 26 to Mar. 31. Over the same period, the ProShares UltraShort Yen Exchange Traded Fund gained more than 20%. But this ETF is not for the faint at heart: It uses leverage to deliver double the daily gains—or losses—of the dollar's price to the yen. *–Tara Kalwarski*

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HOW TO PLAY IT | APPAREL MAKERS


STRATEGY & COMPETITION

Urban Outfitters' Grow-Slow Strategy

By studying local fashions first, it hopes to succeed in Europe where others have stumbled

(FROM PAGE 56)

By Michael Arndt

The four-story mural of underdressed male athletes at Abercrombie & Fitch's New York City flagship store is an impressive display of heroic beefcake—at least until you compare it with the 11-story mural by the same American artist, Mark Beard, in Abercrombie's Tokyo megastore, which opened in December. The prices in the Tokyo store, in the high-rent Ginza district, are grander as well—60% to 80% higher than in Abercrombie's U.S. stores.

American apparel makers are accelerating plans to expand abroad. Some are doing so because there's no room to grow at home. Others see the move as a way to compound strong U.S. growth. Either way, it's a path to raise their growth profile, says Susie Hultquist, a portfolio manager with Columbia Wanger Asset Management. It won't necessarily work for all of them.

Abercrombie is the latest big brand to make the move. It opened its first flagship outside the U.S. in 2008, in London. Milan and Tokyo followed in 2009. Copenhagen is next, this year. A+F has 12 Hollister teen jean stores in malls in Europe and will add 30 in 2010. It says the European unit has been a bright spot—and it needs one. As U.S. teens have turned to other brands, including Urban Outfitters, overall same-store sales fell 13% in its fiscal fourth quarter, which ended Jan. 30, the ninth down quarter in a row. There won't be enough new stores in Europe and Japan to lift its stock anytime soon, says analyst Erika K. Maschmeyer of Robert W. Baird & Co. Shares are around 32, down more than 60% from a 2007 high of 84.51.


A+F's Tokyo store, opened in December (below), features an 11-story mural similar to one at its New York flagship store (above)

While A+F's revenues are down, Urban Outfitters' net store sales rose 4% in the year ending Jan. 31. It's about to open its 20th European store, with plans to hit 200 over the next decade. The company is scouting sites in Asia and still has room to grow at home. Maschmeyer says North America can support 500 Urban Outfitters and Anthropologie women's apparel stores; currently there are 273. Its stock trades at 31 after clearing 35 on Dec. 29. Goldman Sachs analyst Michelle Tan says shares could reach 40 within six months.

Like Urban, discount retailer TJX isn't hurting at home, though it, too, is trying to secure its niche overseas. It is Europe's largest off-price retailer, with more than 260 T.K. Maxx stores (the J becomes a K in Europe) in Britain, Ireland, Germany, and, as of 2009, Poland. Its goal is to double its T.K. Maxx store count. European operations were on track to top $2 billion in sales, or 11% of the total, in the year ended Jan. 31. But those revenues have been declining because of a stronger dollar. Margins have been lower, too, in part because TJX has been spending more than $125 million a year on store construction and other capital expenses. Analyst Kimberly Picciola of Morningstar says profits should rise as TJX gains scale but that merchandising costs will also rise as suppliers unload fewer goods at bargain-basement prices. Shares trade at 38.40 after hitting a record 40.22 in October. Its trailing 12-month price-earnings ratio is 15.7, vs. the Standard & Poor's 500-stock index's 18.8. Picciola says the stock's fair value is 35.

Another overseas veteran is Polo Ralph Lauren, which owns 58 stores outside the U.S. (An additional 151 Ralph Lauren and 60 Club Monaco shops are operated by licensees; Ralphwear is sold in nearly 3,900 other stores in Europe alone.) Foreign sales are a third of revenue, up from less than 25% a decade ago. Long-term, the company wants two-thirds of revenue to come from abroad. Polo Ralph Lauren's same-store sales are up, and its net income increased 6% in the quarter ended Dec. 26. An impressive showing, but Steven M. Rogé, a portfolio manager of R.W. Rogé & Co., says the stock is too expensive now. At 79, it trades at about 17 times trailing 12-month earnings. Rogé would buy it if it fell to 40—it slumped to 31.94 last March—or 12 times earnings. | BW |



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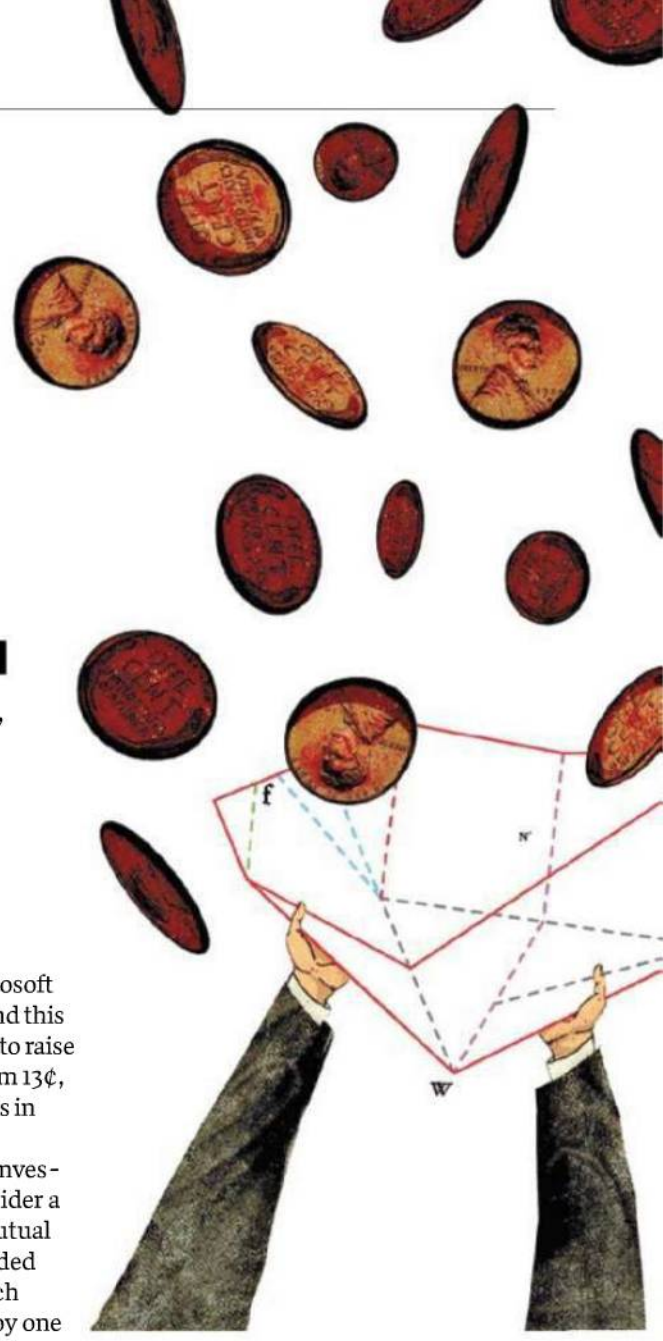
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MUTUAL FUNDS

IN SEARCH OF DIVIDENDS

By Lewis Braham

The junk stock rally is officially over. Or so says John Gould, co-manager of the Cullen High Dividend Equity Fund. "Last year, the 363 stocks in the Standard & Poor's 500 that pay dividends gained 26.2%, while nondividend payers gained 65.3%," he says. "Low-quality companies with no dividends and no earnings outperformed—typical for a market recovering off extreme bear market lows. But we're entering a new phase. The best performers in the last four months have been strong dividend payers."

That Gould sees paying a dividend as a sign of corporate strength should come as no surprise to anyone familiar with market history. Since 1972 the average dividend-paying stock in the S&P 500-stock index has produced an 8.5% annualized total return. That compares with 1.2% for nondividend-paying stocks and 6.8% for the S&P 500 as a whole, according to Ned Davis Research. The outperformance was achieved with one-third less volatility than with nondividend payers.

Unfortunately, the average dividend yield for stocks is 2.2%—far from the 5.4% average yield stocks paid after the last great crash in 1974. But yields are likely to pick up. With bank accounts paying almost nothing and bonds little more than 3% or 4%, investors are hungry for income. What's more, many companies that hoarded cash in the downturn are sitting on more than they know what to do with now. Cash as a percentage of total assets on corporate balance sheets was 12.5% at the end of 2009—the highest percentage on record. "Microsoft is sitting on $36 billion in cash," says Gould. "What is it going to do with that? I'd be surprised if it didn't announce another dividend increase before 2010 is over." (Bloomberg's dividend forecasting team, which uses seven factors to project future payouts, expects Microsoft to maintain its dividend this quarter and next, and to raise it to 14¢ per share, from 13¢, in subsequent quarters in 2010.)

To play this trend, investors may want to consider a dividend-oriented mutual fund or exchange-traded fund. Managers of such funds generally employ one of three styles: equity-income, dividend growth and dividend capture.

Equity-income funds are usually the most conservative, seeking stable high current dividend yields. Allianz Dividend Value and American Century Equity Income fall into this category. "We want companies to have sustainable dividends," says American Century's manager Phil Davidson. "We buy their stocks when they're out of favor and their yields are above average vs. their history. But first we do a lot of work analyzing their balance sheets to make sure their dividends are sustainable."

If Davidson is unsure about the sustainability of a company's dividend but still thinks it is attractively valued, he may buy its convertible bonds instead, since those securities have more downside protection. (The bonds, which are convertible into the company's stock, are senior to stocks in a company's capital struc-

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ture, and so have first dibs on the company's income stream.) So though he owns common stock in steady Eddies such as AT&T, which has a 6.7% yield, he'd rather hold convertibles of the more fragile Bank of America and U.S. Bancorp. Davidson's defensive strategy helped limit his losses during downturns. In 2008, American Century Equity Income lost 20.1%, vs. the market's 37% slide, and its 7.9% 10-year annualized return beats 98% of its peers.

By contrast, a dividend growth manager such as Donald Kilbride of Vanguard Dividend Growth cares less about current yield than the prospect for future dividend increases. "When I talk to investors, I try to get the conversation away from current yield," he says. "I'm thinking about a stock's future yield over the next five years." So his fund has a lower 2.2% yield than Davidson's 2.8%, although not much lower, thanks to Vanguard's 0.32% expense ratio.

Kilbride argues that his strategy can be less risky than equity income funds since he is not chasing the highest yield. "A lot of the high-yielding stocks in 2008 were financial stocks," he says. "We determined these were not dividend growers and that their underlying fundamentals couldn't support their current payouts." By avoiding banks and instead holding stalwarts such as shipper United Parcel Service, which has a moderate 3.3% yield but strong growth prospects, Vanguard Dividend Growth beat the broad market in 2008, falling 25%. It has beaten 95% of its peers in the past five years.

CORRALING THE CASH

	1-YEAR RETURN*	5-YEAR RETURN*
STRATEGY: EQUITY INCOME		
Allianz NFJ Dividend Value D/PEIDX	24.02%	-0.12%
American Century Equity Income/TWEIX	16.48	1.64
Cullen High Dividend Equity/CHDEX	20.19	0.69
Vanguard High Dividend Yield ETF/VYM	31.40	n/a
STRATEGY: DIVIDEND GROWTH		
TCW Dividend Focused/TGIGX	40.13	-2.28
Vanguard Dividend Appreciation ETF/VIG	26.94	n/a
Vanguard Dividend Growth/VDIGX	24.29	3.22
STRATEGY: DIVIDEND CAPTURE		
Alpine Dynamic Dividend/ADVDX	23.86	-3.60
Claymore/Zacks Dividend Rotation ETF/IRO	61.93	n/a
Huntington Dividend Capture/HDCTX	38.90	-0.65

*Annualized total returns as of Feb. 11, 2010, including reinvestment of all capital gains and dividends. Data: Morningstar

BRIAN STAUFFER

Clearly, the ideal balance would be to invest in companies with both high yields and strong growth prospects, and some funds try to do just that. Cullen High Dividend and TCW Dividend Focused combine these strategies but Cullen leans more toward equity income, TCW toward dividend growth. Other managers employ novel strategies to boost yields. The most common is called dividend capture. To "capture" as many dividends as possible, managers buy stocks right before their payouts and sell them soon afterwards, then move on to the next dividend stock.

TURNOVER TIMING

By using such a strategy, the Alpine Dynamic Dividend Fund currently yields 17%. "We typically hold stocks for at least 61 days after they pay their dividends so the payout qualifies for the better dividend tax rate of 15%," says Alpine co-manager Kevin Shacknofsky. "We also buy stocks of companies right before they're about to make a special one-time dividend."

Such a strategy has risks. For one, transaction costs are typically high as managers must trade stocks to capture the dividends. Alpine's turnover ratio is 323%, more than 10 times that of Vanguard Dividend Growth. Also, such managers may have a tendency to chase stocks with the highest yields. Alpine's yield-chasing burned it badly in 2008 as the fund fell 49%. Shacknofsky says he learned from the experience. He now holds a basket of more stable blue chips such as McDonald's and Johnson & Johnson in addition to his more aggressive plays.

Although high-yielding stocks with strong growth rates are rare in the U.S., they are far more common overseas, especially in emerging markets. "From 2002 through 2009, dividends in Asian stocks grew 18% per year on average, compared to just 6% for U.S. stocks," says manager Jesper Madsen of the Matthews Asia Dividend Fund. "Throughout that period, the yield on Asian stocks was about half a percentage point higher than U.S. stocks." Currently, he says, the average Asian stock yields 2.6%, or 3.1% if you exclude Japanese stocks.

Madsen's strategy, like that of other dividend funds, held up better in the downturn. His fund fell 26% in 2008, while the average Asia Pacific fund dropped 43%. But unlike his U.S.-oriented peers, he outperformed during last year's rally, gaining 47.6% while the average Asia fund returned only 34.7%. For dividend-hungry investors, his fund may be one where you can have your income and your growth, too. |BW|

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Coremetrics
Relentless Made Easy

The New Fundamentals:
Technology's Impact on the Future of Marketing

Today, marketing is not for the faint of heart: marketers continually face social and technological trends to which they must react and adapt.



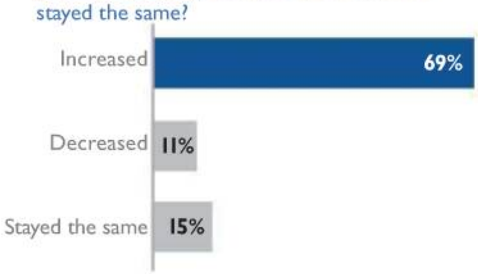
The technology revolution of the past 15 years has had a tremendous impact on the practice of marketing, as more and more dollars migrate from traditional—sometimes called "offline"—marketing (such as print, radio, TV) to the Internet.

While the fundamentals of marketing have not changed (they still relate to putting the right value proposition in front of the right customer at the right time), the technology powering it has. The ability to market online holds the promise of a more personal user experience for customers, while delivering deeper insight into customers' preferences to the marketer, who must interpret customers' behavior.

Online Rising

Bloomberg BusinessWeek Research Services and Coremetrics recently conducted a research program exploring issues around online marketing, and found most companies have increased their spending in this area. While online marketing has put more data and flexibility into the hands of marketing executives it has also put more power into the hands of their customers. The key is in understanding just how powerful its value has, and can, become.

Q: Compared to last year has your spending in (Online Marketing) increased, decreased or stayed the same?



Immediacy and precision rule. No longer do executives throw hard-won budget dollars into the media stream hoping that someone down river will see their advertisement. In fact, today's online marketing environment offers a rich menu of options for reaching the customer with targeted methods. The result, however, is more data than ever before. Marketers must then interpret the meaning, implication, and importance of this data in order to make the most of this information and, of course, optimize their allocated budget.

Though the online world used to represent a fraction of marketing spend for businesses, it's increasingly becoming a larger part of overall marketing budgets and strategies. And while executives in charge of marketing spend know that online marketing is very different from offline, many are finding it difficult to measure the metrics and key performance indicators that determine their strategies and set their budgets.

But without the right tools, mined data is useless, preventing marketers from delivering on their commitments. According to this study two of the top challenges facing marketers are obtaining an integrated view of customers across online marketing touch points (45% of marketers surveyed), and interpreting the resulting data (41%).

The Challenge

The key test for marketing executives is how to transform "data" into "action." Innovations in online marketing tools can turn data into additional revenue by enabling personalized, real-time interaction with each individual customer, providing advertisements based on customer behavior and evident preferences, and delivering relevant marketing information that marketers can use to continue to offer an appealing and personalized shopping experience.

But while most marketers report a desire to tailor their marketing efforts to customer preferences, their current technology use does not support their goal: 8 in 10 marketers (81%) claim that it's very important for them to increase visitor value through compelling product and content offerings, but only 5 in 10 report really using personalized online tools (51%).

ABOUT THIS STUDY

This research program, *The Face of the New Marketer*, was conducted by Bloomberg BusinessWeek Research Services in conjunction with Coremetrics. The research was carried out in September and October 2009 to determine the attitudes and opinions of marketing executives with regard to the current online marketing landscape, the future of online marketing, and the use and value of online marketing tools. The study consisted of 361 interviews with senior marketing executives. More information about this study can be found at www.coremetricsBW.com.

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The opportunity for today's marketers is to better optimize how they enhance their customers' experience; not only because it serves their company's best interests, but because it serves the needs of their customers.

Key Take Away: A Single View

To address the disconnect occurring in the online business world, marketers need to change the way data is processed by way of three fundamental methods: technology-enabled collaboration, multichannel marketing, and personalization. The goal, say industry experts, is to focus on these fundamental methods and integrate offline and online operations into a "single view," to deliver great customer experiences and drive revenue.

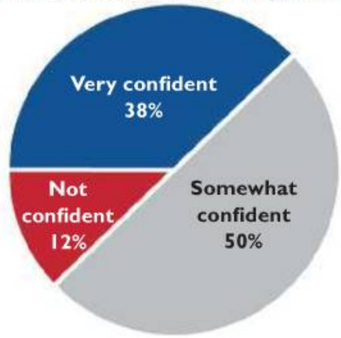
The method is clear, yet many companies don't have the tools to put it into practice. Only 58% of marketers report that they use technology to measure and compare all channels' performance in one view. Most observers agree that adopting true multichannel capability will be key to their future success, enabling them to gain customer insight while opening up new opportunities for their business.

Transition to Better Online Measurement

The speed and accuracy of 24/7, global online marketing represents a power that marketers have not had in all of modern business history. But in many cases that power is still more potential than real, because they have not had the tools to fulfill the promise of a real-time, holistic view into their customers' wants and needs.

Most tools for managing and measuring online activities are still very nascent, adding a layer of uncertainty for marketers, over half of whom aren't confident in their metrics (62%). This is probably the biggest opportunity for marketing technology today.

Q: How confident are you that you are tracking the right metrics for online marketing performance?



Fundamental for the Future

While the core concepts of marketing have not changed, the Internet provides opportunities to engage with customers in a way that marketers a generation ago could not have imagined. According to the Director of Web and Digital Communications at Seton Hall University, "Coremetrics gives us one place to go to get all the data we need and to look at our marketing efforts from a holistic perspective. It helps us understand the complete process for acquiring new students, so we can determine the best way to allocate our marketing spend."

Marketing executives and managers who embrace optimization technology will be well-positioned for the future of marketing. Investing in collaboration, driving toward multichannel marketing, and focusing on delivering a personalized customer experience will create a lasting competitive advantage. The transition to optimizing online may indeed pose challenges for the modern marketer, but the companies who do make this transition become the true innovators.

—Written by Henry Gentenaar

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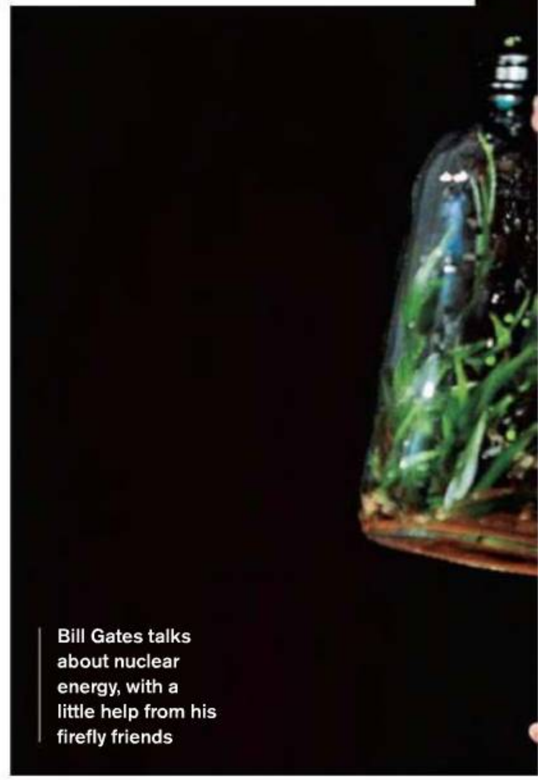
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INNOVATION By HELEN WALTERS

TED's Not Dead, But It Is Aging

The annual conference tries to reach out to a new generation, awkwardly



Bill Gates talks about nuclear energy, with a little help from his firefly friends

TED was born in 1984 as an underground dinner party for information designer Richard Saul Wurman and friends from the worlds of technology, entertainment, and design. This year, 1,500 people paid $6,000 each to attend the modern version of TED, held in the Long Beach (Calif.) Performing Arts Center from Feb. 9-13. Five hundred more paid $3,750 to watch a simulcast of the event—known mostly for its TEDTalks, free-form lectures delivered over the years by the likes of Al Gore, J.J. Abrams, and Dr. Jill Bolte Taylor—at the Riviera Resort & Spa in Palm Springs. In its ability to gather A-list guests, create intellectual buzz, and get celebrities (Will Smith, Cameron Diaz) and billionaires (Sergey Brin, Jeff Bezos) to pay for the privilege of being in a room where ideas might be hatched, TED is quite possibly the most successful dinner party ever thrown.

Success, however, is not a sinecure. Twenty-six years in, TED is showing signs of age. One of the most conspicuous is the makeup of attendees, diverse only in that TED appears to attract a white man from every street in Silicon Valley. (Not that there's anything wrong with that, says TED's community director, Tom Rielly: "These are great people.") Other big-time conferences—the annual World Economic Forum in Davos among them—have struggled with similar issues, like: how to get more inclusive without sacrificing intimacy. How to keep loyalists happy while attracting a younger crowd closer to the headwaters of innovation. And how to get that younger crowd to pay six grand.

Solving these problems before they endanger the franchise is clearly on the minds of TED's 50 or so full-time employees. Which explains the gamut-running 2010 presence of both philanthropist Bill Gates and adorably foul-mouthed comedian Sarah Silverman. In a clear sign of how hard it is to change TED's culture, Gates killed. Silverman got killed.

Her routine, which involved adopting a terminally ill special-needs child and 10 or so uses of the "r" word, left much of the TED audience mortified (though there was scattered applause). It also earned the 39-year-old comic a disparaging tweet from Chris Anderson, the former magazine executive who bought TED in 2001. "I know I shouldn't say this about one of my own speakers," tweeted Anderson, "but I thought Sarah Silverman was god-awful." Anderson tried to recall the tweet, but it was too late, and before long Steve Case was trashing Silverman, Silverman was baiting Case ("You should be nicer to the last person on earth with an AOL account") and the whole experiment in hipness had turned into an embarrassment.

PHOTOGRAPHS BY JAMES DUNCAN DAVIDSON/TED

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TED IS DIVERSE ONLY IN THAT IT APPEARS TO ATTRACT A WHITE MAN FROM EVERY STREET IN SILICON VALLEY

"TED OPENS DOORS"

Anderson may have better luck reaching the next generation with the TED fellows program, launched in 2009. Fellows—to cite TED—are "young world-changers and trailblazers" from such places as Karachi, Nairobi, and São Paulo, "who have shown unusual accomplishment and exceptional courage." Each gets an all-expenses-paid trip to TED.

It wasn't hard to spot the 45 fellows in attendance. Bola Olabisi, a founder of a Nigerian nonprofit that aims to improve conditions and opportunities for women, was sitting on a cushion wearing a brightly hued African dress and head wrap. "TED opens doors," she says. Erik Hersman, the founder of Ushahidi, a Kenyan Web site that uses crowdsourcing to help activists organize, was happy to be at TED, if unawed by the established stars. "Yes, you walk out of the restaurant and there's Sergey Brin," says Hersman, 34. "Then you turn around and there's Ev [Evan Williams] from Twitter. But you don't treat anybody special. At the end of the day we all put our pants on the same way." Perhaps. But from his dedicated tweeting and occasional gapes, you could tell Hersman was amped to be there.

And why not? TED's pioneers remain an undeniable draw. Bill Gates clambered onto the stage with a jar full of fireflies and made the case for TerraPower, a venture that's developing nuclear power using natural or depleted uranium. David Cameron, the leader of Britain's Conservative Party, beamed in from London to outline his ideas for open government. Brin made a brief appearance to explain Google's policies in China, saying: "I want to find a way to work within the system and provide more and better information."

As it happens, TED may have stumbled into a strategy for bridging its generation gap. Those who can't attend in person can now pay $995 to stream the event live on the Web. As two-time speaker Seth Godin puts it, "TED is a TV show that happens to have a conference." Or a dinner party that just won't end. **BW**



Silverman was invited to bring a hipper vibe to TED; it didn't work out so well

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BOOKS

BY JAMES PRESSLEY

They Did the Math—And Lost Billions

Quantitative investors often make a killing. But when they're overextended and the markets turn, they can end up making a mess

On Aug. 7, 2007, Matthew Rothman of Lehman Brothers Holdings got off a red-eye flight in San Francisco and went to see a potential client. "Oh my God, Matthew," the trader said, pulling Rothman toward his office. "Have you seen what's going on?" His portfolio was tanking, and the bloodletting continued as Rothman visited other quant funds that Tuesday, writes Scott Patterson in his sometimes overheated yet valuable book, *The Quants*.

Rothman, a quantitative strategist, was baffled: "Events that models only predicted would happen once in 10,000 years happened every day for three days." Suddenly, the quant math didn't add up.

The rise of quantitative investing is one of the great financial developments of our times. Equipped with advanced degrees and superfast computers, quants revolutionized Wall Street. They also hastened meltdowns ranging from Black Monday in 1987 to the collapse of Long-Term Capital Management in 1998 and the Great Credit Crackup of 2007.

Most investors know little about the quants' intellectual zealotry, arcane models, and power to pump money into—and out of—the system. Patterson, a *Wall Street Journal* reporter, sheds light on their secretive world by tracking the turbulent lives of four quants. Kenneth Griffin is the best known of the quartet—the math whiz who began trading convertible bonds in his Harvard dorm room and founded Citadel Investment Group at age 22. The others are Clifford Asness of AQR Capital Management, Peter Muller of Morgan Stanley's Process Driven Trading unit, and Boaz Weinstein of Saba Capital Management.

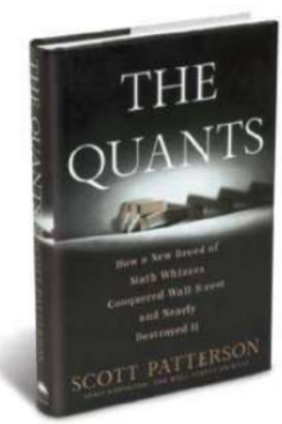
The story radiates with hubris, high stakes, and pricey toys, giving glimpses of poker tournaments at the St. Regis Hotel in Manhattan; a stretch limo ride to a paintball fight outside Las Vegas; and Griffin's garage full of Ferraris. With so much money to be made, the quants didn't heed warnings from gadflies such as Nassim Nicholas Taleb, who pounds a table in one scene, agitated by Muller's confidence. "You will be wiped out!" Taleb shouts. "I swear it!"

Patterson is fond of clichés, and the book opens with "gem-studded dresses," "testosterone-fueled competition," and "well-heeled players." Ignore the hype and press on. The prose grows less breathless as he explores the origins of quantitative finance.

The quants, it turns out, could have spared us a world of grief by heeding their godfather, Edward Thorp. A mathematics professor, Thorp began using math to make money in the 1960s, first at blackjack tables, then on Wall Street. His writings influenced a generation of quants, building on an observation from Frenchman Louis Bachelier in 1900 that prices on financial markets seemed to oscillate as randomly as pollen particles.

To some, that meant it was impossible to beat the market. Thorp saw something different—a way of calculating whether stock warrants were correctly priced. His conclusion: Most warrants cost too much, given the amount you could win and your odds of doing so. Before long, Thorp was making so much money off these derivative securities that he set up a hedge fund.

The quants who copied him, however, ignored a vital piece of his strategy. Thorp, like Taleb, was keenly aware that nonrandom events can wreak havoc on models. So he scaled his bets to his bankroll, committing only a prescribed fraction.



The Quants: How a New Breed of Math Whizzes Conquered Wall Street and Nearly Destroyed It **by Scott Patterson; Crown Business; $27; 337 pp**

The bubble eventually burst, of course. By October 2008, Citadel was on the verge of collapse, and Muller's PDT was in crisis mode at Morgan Stanley, Patterson says. AQR was out billions, he writes, and Asness was out of control, smashing chairs and punching computer screens. Losses were mounting at Weinstein's Saba group at Deutsche Bank. (He kept the name Saba when he left Deutsche.)

What did Thorp make of his followers? Patterson visited him in Newport Beach, Calif., to find out. It was February 2008, and Thorp was angry. Banks and hedge funds were blowing up because they ignored what risk management is all about: never betting so much that you can lose it all. They were overbetting and using borrowed money to do it. "Any good investment, sufficiently leveraged, can lead to ruin," Thorp said. It's a lesson that's forgotten in every boom. |BW|

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OUTSIDE SHOT

By DEREK DeCLOET

What U.S. Banks Can Learn from Canada

While America's bailed-out banks lobby against reform, Canada's profitable banks are asking for more

On the night hockey superstar Wayne Gretzky lit the cauldron to open the Winter Games, something was conspicuously absent in the host city: winter. With rain and temperatures near 50F, Vancouver was the focus of a weather-obsessed nation.

Right now, Canada's business community is fretting about a different sort of climate event. The country's housing market is so hot, and has become so untethered from its foreclosure-ridden U.S. counterpart, that alarms are beginning to sound about a Canadian real estate bubble. In Toronto, the average home in January sold for about $392,000 (U.S.), a 19% jump from a year earlier. In prime areas of Vancouver, you can find Lilliputian one-bedroom condos listed for $575,000 or more. Price increases are forecast for every province.

For a country whose economic fortunes usually move in lockstep with America's, this is an odd—and disconcerting—phenomenon. The most surprising part is who's trying to cool off home prices: Canada's top bankers. They earn huge profits from mortgages. Yet the leaders of the major banks recently urged the government to tighten mortgage rules to chill down the market, even though that would cut into profits in the short term. And the government quickly responded, announcing changes on Feb. 16 that enforce stricter requirements for borrowers, among other (tougher) rules.

This effort may be the surest sign yet of the gulf between the Canadian and American financial systems. More than $1 billion in goods cross the border daily, but when it comes to banking, the two countries are leagues apart, and the credit crisis proved it. Canada did not have to bail out its banks (though Ottawa did adopt measures to lubricate the credit markets). When American and European banks were teetering in 2008, only one of



Canada's six major banks reported a loss. Last year, none did.

The stability hasn't gone unnoticed. Canada's bankers have won admiration from President Barack Obama, former Federal Reserve Chairman Paul Volcker, and Nobel prize-winning economist Paul Krugman, among others. What explains the success? Krugman points to stricter regulation—certainly a factor but not the whole story. Yes, regulators kept Canadian banks from taking on too much debt, which helped them through the crisis, but there were cultural and business reasons at play, too.

As in the U.S., it comes back to real estate. Canadian banks did not fail because they mostly avoided the big mistakes with mortgages. They didn't lend to people who couldn't prove a sufficient income. They did give no-money-down mortgages, but not many—and the practice was effectively banned. They made scant use of teaser rates.

They didn't they do these things largely because they didn't have to. Domestic banks own 80% of the mortgage business, and most of that is in the hands of the Big Six. Refinancing is expensive and a hassle. Canadian tax law also plays a role. Mortgage interest isn't tax-deductible, creating a disincentive to borrow. And heaven help the defaulter; banks can go after assets other than the home to make themselves whole.

All of these elements make home loans a low-risk business, so Canadian banks tend to keep their mortgages rather than bundle and sell them. That forces careful lending, which leads to profits, which leads to healthy banks, which leads to more lending—a virtuous circle. Royal Bank of Canada, the largest institution, holds $117 billion in residential mortgages, more than 40% of its loan portfolio. "That's the core of the balance sheet of Canadian banks," says Rob Wessel of investment firm Hamilton Capital Partners. RBC's provision for losses on domestic mortgages last year? Less than $18 million.

It's a great business, and the formula is dead simple. "Just stop doing the stupid things, and these are money machines like God has never created before," Ed Clark, CEO of Toronto-Dominion Bank, said last year. By acting together, Canada's banks and government may prevent a full-blown bubble. But don't expect bragging. Like a snowless winter, that would be un-Canadian. |BW|

Derek DeCloet is managing editor of business at The Globe and Mail, *the national newspaper of Canada.*

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